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THE FREEMAN

Published by
The Foundation for Economic Education
Irvington-on-Hudson, NY 10533
Phone: (914) 591-7230; E-mail: freeman@fee.org
www.fee.org

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FEE The Foundation for Economic Education (FEE) is a non-political, non-profit educational champion of individual liberty, private property, the free market, and constitutionally limited government.

The Freeman is published monthly, except for combined January-February and July-August issues. Views expressed by the authors do not necessarily reflect those of FEE's officers and trustees. To receive a sample copy, or to have *The Freeman* come regularly to your door, call 800-960-4333, or e-mail mnolan@fee.org.

The Freeman is available on microfilm from University Microfilm International, 300 North Zeeb Road, Ann Arbor, MI 48106.

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Cover: International Monetary Fund

Perspective

Paul Krugman Flunks Capital Theory

Nobel laureate and *New York Times* columnist Paul Krugman is said to have bested commentator George Will over what prolonged the Great Depression during a joint appearance on ABC's "This Week with George Stephanopoulos" back in November. But all Krugman really did was show that he, as a Keynesian, holds an unrealistic Play-Doh model of capital, as opposed to the more realistic heterogeneous, multistage, intertemporal structure-of-production model of the Austrian school of economics.

Here's what actually happened. During the roundtable segment of the show, Will said, "[O]ne of the ways we turned a depression into the Great Depression . . . was that there were no rules and investors went on strike because the government was completely improvising. Net investment was negative through almost all of the '30s because, again, people did not know the environment in which they were operating because the government had the fidgets and would not let rules and markets work."

Krugman responded, "Well, it's not the way I read the history. . . . No, the negative net investment was because, you know, when you have 20 percent unemployment and all the factories are standing idle, who wants to build a new one? You don't need to invoke the government to explain that."

Point Krugman? Wrong.

If Krugman took the Mises-Hayek capital and trade-cycle theory seriously he'd realize that the idle factories in the 1930s represented malinvestment induced by Federal Reserve credit expansion in the 1920s. By lowering the interest rate and falsely signaling an increase in saving (that is, a preference for future over present goods), this policy shifted resources from later stages of production (closer to the consumer) to earlier stages of production. Unfortunately, those who think of capital as a heap of uniform, monochrome Play-Doh aren't sensitive to this point. Capital is capital is capital. That's why Krugman can't understand why someone would want to invest in new facilities when others stand idle.

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When the 1920s inflationary boom ended, as it had to because it was artificially induced and there weren't enough resources for both the early stages *and* the later stages (where consumers wanted them), the malinvestments had to be liquidated and scarce resources had to be redeployed. But since capital consists not of malleable Play-Doh but rather of discrete things—buildings, machines, tools, materials—with particular characteristics, many of these products of malinvestment were unsuitable for other purposes. They couldn't simply, costlessly, and instantly be moved and employed in later stages of production. Hence the idle factories. This was wasted capital brought about by the credit expansion. This was the Depression.

If the economy was to recover, new investment consistent with consumers' actual preferences had to be undertaken. But that required time and saving—that is, deferred consumption, not the pumped-up consumer spending Krugman favors. It also required a stable political environment in which investors could be confident their property was safe from government predation. Unfortunately, thanks to tax increases, an unending stream of interventionist programs, and threatening antibusiness rhetoric, FDR's government failed to provide that environment.

Krugman's flip remark to Will is thus a perfect illustration of what is wrong with Keynesian economics.

P.S. Will and Krugman believe it took World War II—"an enormous public works program," in Krugman's words—to end the depression. Both are wrong about that, as Robert Higgs documents in *Depression, War, and Cold War*. Ending unemployment with a military draft and boosting GNP through military contracts do not a recovery make. Living standards could hardly rise amid ration books, consumer-goods shortages, and war production.

★ ★ ★

Keynes is back, which is great for politicians and court economists. It's not such good news for the rest of us, though. Peter Lewin explains why.

The economic theory of John Maynard Keynes shifted focus from microeconomics, the decisions of individuals, to macroeconomics, the economy in the aggregate. The consequences for policymaking in the current crisis are significant, as Mario Rizzo demonstrates.

And what exactly is wrong with Keynesian theory? In a *Freeman* reprint from 1993, Roger Garrison goes to the heart of the matter.

"Derivatives" has become the demon word in this time of economic turmoil. Not easily understood, they make an easy scapegoat for the recession. Not so fast, writes Less Antman.

If the division of labor is beneficial to all and, as Adam Smith wrote, "limited by the extent of the market," then a worldwide market is what we should want. That point is well argued by Gennady Stolyarov II in his winning entry in FEE's first Eugene S. Thorpe Essay Context.

Somalia is much in the news—and not for good things. But there's another side to the country that features economic growth and peaceful trade. Not bad for a place without a central government. Benjamin Powell has the scoop.

Our columnists have cooked up the following treats: Lawrence Reed recognizes a fighter for liberty. Donald Boudreaux continues his reconsideration of the Mises-Hayek trade-cycle theory. Burton Folsom has the goods on FDR's National Recovery Administration. John Stossel shows that Bernard Madoff has nothing on the Social Security Administration. Walter Williams compares the political and market arenas. And E. Frank Stephenson, having watched T. Boone Pickens promote energy subsidies on television once too often, retorts, "It Just Ain't So!"

Books undergoing scrutiny in this issue deal with economics in novel form, immigration, private property, and biotechnology as a way to grow more food.

Capital Letters features a response to our article about energy independence.

—*Sheldon Richman*
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The Sage of Tampa

BY LAWRENCE W. REED

"The natural progress of things," according to Thomas Jefferson, "is for government to gain ground and for liberty to yield." But this lament does not suggest that the primary author of the Declaration of Independence was resigned to inaction. He also said, "A little rebellion now and then is a good thing, and as necessary in the political world as storms in the physical."

Jefferson was right on both counts, which is why we should be grateful for good people who push back when government pushes where it shouldn't. Liberty would surely be a lost cause without them.

One such person is Harry Teasley of Tampa, Florida. I've come to know Harry as man who generously commits everything—reputation, intellect, energy, time, and resources—to the idea that government must retreat so that liberty may advance. Not even age (he's 71) seems to slow him down.

Thirty minutes with Harry and anyone familiar with the famed Myers-Briggs personality profile test would likely guess that Harry is an "INTJ"—one of an estimated 2 percent of the American population. As fits the description, Harry is a keen observer of the world who places a premium on evidence, logic, and facts. His thinking is deliberate, systematic, strategic, and long-range. He abhors incompetence and does not suffer gladly the many fools, charlatans, and gullible fuzzy heads who feast off the production of others or opine on anything that strikes their fancy. An engineer by training and a natural leader, he is self-confident, intuitive, and decisive.

Like his thinking, his desk is organized and clutter-free. He knows what he believes in and is not timid about standing up for it. Many people who have been on the other side of arguments with Harry have scars to prove it.

A January 10, 1995 article by Tim W. Ferguson in the *Wall Street Journal* acquainted a national audience with how Harry had just "stared down" the Tampa mayor and his allies in the local business community. At issue was a proposal to build a publicly subsidized hotel near a $140 million convention center. It had already secured huge subsidies before Harry arrived in Tampa in 1991. The hotel would likely cost the taxpayers more than the convention center itself and would compete directly against private taxpaying hotels. To Harry the matter was not about economic development. It was instead a *moral* and *philosophical* matter that "had to be fought on the high ground of what is the appropriate role of government."

> We should be grateful for good people who push back when government pushes where it shouldn't. Liberty would surely be a lost cause without them.

"I always come back to first principles and debate from first principles," Harry told Ferguson. "It protects against cracks in the armament." He organized and inspired opposition to the hotel, commissioned a voter survey that revealed strong public antipathy to the subsidy, blew apart the arguments of the mayor's consultant's report on the project, bought full-page ads in the local paper, and turned out a big crowd at a crucial city council meeting in October 1994. Under the pressure the council rejected the hotel subsidy by a 4-3 vote.

Harry Teasley was no stranger to controversy. Before that dust-up in Tampa, he had spent more than three decades as an executive with Coca-Cola in Atlanta, in a

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series of positions and locations that brought him into conflict with overzealous government regulators and fact-deficient environmental activists. When Maine outlawed the aseptic packaging more popularly known as drink boxes, he proved the boxes conserved resources instead of squandering them. Maine repealed its ill-advised ban. While he was president of Coca-Cola Foods, maker of Minute Maid orange juice, the company stood practically alone in opposing the extension of tariffs on orange solids from Brazil. He also successfully fought a committee (appointed by seven Northeast governors) that wanted to veto the preferences and expertise of producers, packaging engineers, and consumers by regulating the specs of every package sold in those seven states.

Harry warned against the policies that produced today's mortgage market crisis long before the bubble broke. In 2000, when a bank on whose board he served sought to secure subsidies for a housing project the bank stood to profit from, Harry resigned. In his letter to the bank's CEO, he wrote:

> . . . I believe in that set of ideas and concepts that goes under the rubric of *classical liberalism* [emphasis Harry's] to include . . . the following: freedom in all its guises, personal liberty and its mirror image of individual responsibility, private property, economic freedom, free markets and free trade, rule of law, voluntary contracts and association, and limited government.
>
> While I realize that our country has strayed far from the concepts articulated by the Founders and that we are awash in a sea of statism and socialism, nevertheless whenever I encounter government intrusions that are contrary to my beliefs, I try to act in arenas open to me. The granting of subsidies or the redistribution of wealth to special interests, in order to support activities that would not exist if individuals or institutions had to spend their own money, is such an area.

Harry Teasley has long opposed foolish and unwarranted regulation.

Since last summer the federal government has granted trillions in bailouts to a growing list of supplicants lining up at the public trough. I can't help but ask, "Where are the Harry Teasleys? Who has the courage and the moral scruples to keep their hands in their own pockets?"

Harry's principles didn't come from an economics professor. As a student at Georgia Tech in the 1950s, he took an economics course for which the text was an early edition of Paul Samuelson's awful but widely used apologia for central planning. But during rigorous courses in English and engineering, his logical mind found solace in critical thinking, deductive reasoning, and the importance of research rooted in dispassionate, agenda-less evidence. When a professor claimed in a math class that smart government planners using computers could effectively manage a nation's agricultural needs, Harry challenged him. "How could any handful of officials possibly know how to account for endless variables from the weather to consumer tastes?" he demanded to know. He wasn't satisfied with the presumptuous prof's superficial reply.

Thirty years later, in the late 1980s, Harry Teasley formally met the body of thought we know as free-market, classical-liberal economics. The Foundation for Economic Education played an important role in his introduction. He worked from a reading list compiled by FEE's founder Leonard Read and a long-time FEE supporter, Harry Langenberg of St. Louis. In quick succession, Harry devoured *The Freeman* and the works of Frederic Bastiat, Ludwig von Mises, Murray Rothbard, F. A. Hayek and others. An organized mind had connected with the logic of real economics in a seamless and natural marriage. From that point on, the principled crusades against the regulators and the subsidy-seekers were inevitabilities waiting to happen.

Today, Harry Teasley is retired only as a professional business executive. He is otherwise engaged constantly in thinking, writing pithy letters to the editor, and supporting liberty through his time, advice and philanthropy. It was people like him that I'm convinced Jefferson had in mind when he urged, "Enlighten the people generally, and tyranny and oppressions of body and mind will vanish like evil spirits at the dawn of day." FEE

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T. Boone Pickens Is Right About Oil Imports? It Just Ain't So!

BY E. FRANK STEPHENSON

Folksy oilman T. Boone Pickens has taken to the television and radio airwaves with a $58 million campaign to publicize his plan for energy independence. Though he's suffered setbacks, his proposal involves building windmills in Texas to generate electricity. Natural gas that had been used previously for electric generation would then be used to fuel motor vehicles, allowing us to "break the stranglehold of foreign oil."

Pickens's commercials no doubt cause *Freeman* readers apprehension. The word "plan" alone rightly provokes worries of coercive schemes. And in concocting such a plan, Pickens reveals himself to be what Adam Smith called a "man of system [who] seems to imagine that he can arrange the different members of a great society with as much ease as the hand arranges the different pieces upon a chess-board." The notion of being independent of energy or any other commodity from foreign countries goes against the teachings of Smith, Bastiat, and others who recognize the gains from specialization and division of labor. Nor will readers knowledgeable about rent-seeking, or political entrepreneurship, be surprised that media reports describe Pickens as "heavily invested in natural gas and wind power." And when he states in his commercials that "this plan will work but it needs your help," readers familiar with Public Choice economics rightly suspect that the sort of help Pickens has in mind is tax dollars.

Although all these cautions are appropriate, ignore for the moment any self-interested motives and take Pickens at face value when he proclaims, "I'm 80 years old and have $4 billion. I don't need any more money." Instead, focus on the stated objective of his plan—stopping the "the largest transfer of wealth in the history of mankind." As with so many things, it just ain't so!

Here's why. The $700 billion that Americans spend annually to purchase oil from other countries (according to Pickens) is a price not a transfer. A true transfer—unemployment benefits or a taxpayer subsidy to a failing company—is a payment made to someone who provides no good or service in exchange. By nature transfers are zero-sum. One person "gives" through coercive taxation; the other person receives. (Of course, if one throws a few bureaucrats into the mix, the transfer recipients might receive less than the amount taken from the taxpayers.) Ironically, it is Pickens, not oil-exporting countries, who has received transfers in the form of taxpayer subsidies for so-called renewable electricity generation. And that bit about needing your help—Pickens wants the largess to continue.

Ironically, it is Pickens, not oil-exporting countries, who has received transfers in the form of taxpayer subsidies for so-called renewable electricity generation.

By contrast, when one makes a purchase, the money one pays is the price of the good, one side of a mutu-

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ally beneficial voluntary exchange. Each party to the transaction trades away something in return for something else he or she values more highly. If I spend $2 for a cup of coffee, I've made a purchase not a transfer. I get the coffee, which I value more than anything else I could have bought for the $2, and the coffee shop gets the $2, which it values more than the coffee. Readers familiar with John Stossel's television special about greed will recall him illustrating this point by purchasing a container of milk. Both he and the store clerk said, "Thank you."

For the $700 billion we send to oil exporters, we get something in return—*oil*. Our receipt of millions of barrels of oil in exchange for that money is hardly a transfer. We receive a versatile commodity that can be used for everything from making plastics to fueling family vacations. The exporters receive the $700 billion that they can then use to purchase other goods and services.

It is true that when oil was $140 per barrel, we were paying more than we had paid just a few years ago. We certainly are glad that oil is less expensive now. But the case I'm making would hold even if the price went back up. Higher prices would mean that purchasers of oil or oil derivatives would experience a smaller difference between their subjective value and the price they pay. If I valued a gallon of gas at $5 (that is, if I were willing to pay up to $5 for it), my net gain from purchasing it would be greater when I paid $2 than when the price was $4. It's also true that people would find some purchases they might have considered beneficial when oil was, say, $35 per barrel no longer beneficial at $140. Consequently, almost as if guided by an invisible hand, people would reduce their oil consumption by driving less, buying more fuel-efficient vehicles, taking alternative forms of transportation, and so on. Yet none of these truths makes the purchase of foreign oil a transfer.

It is true that much of our imported oil comes from countries with odious regimes. It's also true that exchange with nasty regimes benefits them as it does us. This does not, however, imply that we should boycott them.

It is true that much of our imported oil comes from countries with odious regimes. Indeed, it's difficult to think of countries more antithetical to classical-liberal ideals than Venezuela and Saudi Arabia. It's also true that exchange with nasty regimes benefits them as it does us. This does not, however, imply that we should boycott them. Since oil is traded on the world market, a boycott—at least if unilateral—would not harm the intended targets. Although it might be nice if our oil-trading partners were nice folks in countries with greater respect for individual rights (the Swiss perhaps), the fact that they are unpleasant still doesn't make purchasing imported oil a transfer.

If the price of oil again skyrockets, it will present a significant challenge to consumers and producers. There is no need to make their task more difficult with muddled thinking that confuses mutually beneficial exchanges with wealth transfers. T. Boone Pickens has been a businessman all his adult life. He should know better. If he's putting his quest for taxpayer subsidies ahead of the truth, he is doing the American people a grave disservice.

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Recycling Discredited Ideas

BY PETER LEWIN

The ideas of economists and political philosophers, both when they are right and when they are wrong, are more powerful than is commonly understood. Indeed the world is ruled by little else.

Practical men who believe themselves to be quite exempt from any intellectual influences are usually the slaves of some defunct economist. Madmen in authority, who hear voices in the air, are distilling their frenzy from some academic scribbler of a few years back.

—John Maynard Keynes, 1936.

Unless they have taken a course in economics most people probably have never heard the name John Maynard Keynes. To his contemporaries this English economist, statesman, and general all-around charismatic intellectual was a household name. And to generations of economics students after World War II, he was a hero.

He was the man who invented macroeconomics, the man who revealed to the world how to avoid another Great Depression, the man who made it respectable for governments to target unemployment and to worry about balancing the economy, not the budget. He taught us that it is unnecessary to worry about the long run because "in the long run we are all dead." He taught us that government leadership was necessary to safeguard us from the possible and likely instabilities of the market system. Capitalism was ok. It was the best system we had to ensure economic growth peacefully and democratically. But it needed to be bolstered by enlightened governmental intervention at crucial moments. Most of this came packaged in his book *The General Theory of Employment, Interest, and Money*, published in 1936. It became the basis of the new conventional wisdom.

To be sure, Keynesian ideas were around before Keynes but they were mostly associated with quacks and crackpots.

Teaching a New Generation Old Tricks

To be sure, Keynesian ideas were around before Keynes—but they were mostly associated with quacks and crackpots. Economists before Keynes dismissed the idea that governments could "create jobs" by simply putting people to work on "public works" using money created by the central bank (inflation). After all, if resources were employed in public works they would be unavailable for anything else. Society would have to forgo the alternative product of these resources—that was their opportunity cost. Governments could not simply "create" jobs where none existed before. They could only redistribute jobs away from the private sector into the public sector. And there was no reason to presume that the latter jobs were more valuable to society than the former. An understanding of economic history and of the market process suggested the opposite—namely, that private market decisions in pursuit of profit would tend to produce the most valuable jobs for the most people.

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Keynes secured acceptance for his ideas because of who he was, when he was, and what he was. He was a very powerful personality (to say the least) who came to prominence at the time of the worst economic depression the world had ever faced. He was also the head of the most prestigious university economics department (Cambridge) in the world. He was uniquely placed to take these hitherto dismissed ideas and not only make them respectable but present them as the new revealed truth.

Keynes packaged these ideas in convoluted intellectual garb but he asked some legitimate, penetrating, hard-to-answer questions about how the market works. He suggested that the "dark forces of time and ignorance" made it implausible to suppose that private, mortal entrepreneurs could be relied on to anticipate the future demand for goods and services in any detail. This being the case, Keynes asked, how can we rely on the market to put to work the savings of millions of private individuals? Savings is the sacrifice of present consumption spending for the option to consume in the future. But what guarantee is there that increased saving today could and would be translated into increased consumption tomorrow? After all, increased saving today means less consumption today, and this is likely to discourage entrepreneurs from producing for the future. This is why we need the government to undergird the economy and prevent it from falling into a downward spiral due to the pessimism that could arise from underconsumption (however caused). In a modern monetary economy, private savings do not automatically get translated into private investment. Thus private investment needs to be supplemented and nudged by government investment—and if necessary, it would seem, also by government consumption.

Keynes secured acceptance for his ideas because of who he was, when he was, and what he was.

Blasphemy from Chicago and Austria

The Keynesian message is appealing and intuitive, and it has sold very well. In fact, it testifies to the power of ideas in history. In the postwar period first the academic economists, then the other social scientists, and then the public at large became converts. From the time of John Kennedy onwards American economic policy became self-consciously Keynesian. But there were pockets of strenuous resistance to the new creed—most notably at the University of Chicago (the economists of the Chicago School) and also among many individual economists around the world—notably those trained in the Austrian school of economics. The most prominent Austrians of that period were Ludwig von Mises (then at New York University) and Friedrich Hayek (at the London School of Economics and later at the University of Chicago). The most famous Chicago economist in this context was Milton Friedman—perhaps America's most well-known economist ever. It was Friedman's relentless work (together with his students and colleagues) that paved the way for a sober reconsideration of the new Keynesian orthodoxy and its subsequent overthrow.

My own personal odyssey coincided with that broader cultural shift. I arrived at the University of Chicago in September 1972 to pursue my Ph.D. in economics as an informed and enthusiastic Keynesian. This despite studying in South Africa under Ludwig Lachmann, an adherent to the Austrian School, and in spite of a detailed knowledge of Milton Friedman's monetary theory. Between 1972 and 1976, while I was immersed in a detailed and rigorous examination of market economics, the American economy was being put to the test. Friedman had long been preaching against Keynesian macroeconomic policies (tax, inflate, and spend) and in his presidential address to the American Economic Association (1968) had warned that such policies would lead ultimately to simultaneous inflation and unemployment. By the mid-to-late 1970s this is exactly what happened—a new American word, *stagflation*, was coined to describe it. High levels of both inflation and unemployment emerged, seemingly impervious to the stimulatory actions of government economic policy.

In fact, people now began to suspect what Friedman (and Mises and Hayek and countless others) had been

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saying for years—that government policy was *responsible* for the mess, that government policy, far from being the solution, was itself the problem—could be true. People began to suspect that the pre-Keynesian economists were right in thinking that the market was not inherently unstable (as Keynes has asserted) and that government intervention to improve on market outcomes actually succeeded in destabilizing the market much further. By the end of the 1970s people were ready for a change. It was in this climate of opinion that Ronald Reagan and Margaret Thatcher were elected. When I left Chicago in 1976 I was convinced that Keynesian economics was a fraud, and I have never seen reason to change my mind. I naively thought that my own passage from illusion to enlightenment was characteristic of the public in general and that Keynesianism (at least in its naive form) had been put to bed forever. I had thought that we now understood that inflation and unemployment were not alternatives and that any temporary stimulus achieved by money inflation would be short-lived and would itself cause a boom-bust cycle. The Keynesians had scrambled to put together an even more convoluted version of the story, but I had thought their efforts were basically seen as unsuccessful—at very least by the majority of trained economists.

The current financial crisis has fueled a frenzied recycling of discredited Keynesian ideas.

Don't Call it a Comeback

Clearly not. The current financial crisis has fueled a frenzied recycling of discredited Keynesian ideas. We are hearing again of the need for "public works," of the need to "stimulate" the economy. The Federal Reserve is frantically inflating the supply of money. We are laying the groundwork for a disaster reminiscent of the 1970s—if not worse.

To understand this we need to look at some of the details of the current crisis. The conventional wisdom blames our plight on an over-reliance on the free market, on "too much deregulation." The truth is exactly the opposite. The current debacle is the result of multiple overreaching government regulations and interventions. At the very base of the problem is the Federal Reserve, which has attempted to fine-tune the economy and guide it delicately through ups and downs. The Fed has always been reluctant to be the party pooper that brings any boom to an end. Thus the "natural" end of the dot-com boom was postponed by a reluctance of the Fed to allow interest rates to rise, thus allowing the supply of money to expand to fuel the necessary credit for continued expansion into ever more risky and unsustainable business ventures. When the bust came it came with more pain than necessary. The related housing bubble that followed played out along similar lines.

But the matter is more complicated than simply too much credit for overexpanding sectors of the economy. The housing crisis is the result of a systematic, hard-headed social policy aimed at increasing the number of homeowners in America. Using the politically charged notion that minorities were suffering from discrimination in the mortgage industry (a notion that has been discredited; see, for example, Stan Liebowitz, "A Study that Deserves No Credit," *Wall Street Journal*, September 1, 1993, http://tinyurl.com/8bsjb3 [pdf]), some Democratic politicians made it their mission to rewrite the standards for mortgage approvals and ensure they became the reigning procedures for the industry. In this they were assisted by the quasi-government mortgage-packaging institutions, Fannie Mae, Freddie Mac, and Ginnie Mae. The result was a massive expansion of the production of new houses, an increase in housing prices, and an increase in the proportion of Americans owning their own homes.

The rise in housing prices in turn encouraged creative speculation in financial securitization based on mortgages. It also encouraged speculation in home ownership whereby, with very little or no money down, people could buy multiple homes and profit from the run-up in prices. When housing prices finally started to fall—an inevitable outcome—many people found themselves owing more than the houses were worth and simply walked away from them. Others found themselves facing mortgage payments they could not afford—because of the systematic dumbing-down

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of mortgage standards. (For a comprehensive, penetrating examination, see Stan Liebowitz, "Anatomy of a Trainwreck: Causes of the Mortgage Meltdown," http://tinyurl.com/3m4bzv [pdf].)

In short, we have had a distortion of the economic structure toward the production of items whose value did not justify their production in the first place. This is a structure that cannot be sustained. Resources are "misemployed" and need to be redeployed—a process that is necessarily painful. (The same story characterizes the travails of the auto industry over a much longer period.)

Pay Now or Pay More Later

Against this background one can see that attempts to solve the crisis by simply providing more liquidity or "stimulating" the economy won't work. In fact they will make things worse by creating the illusion that the distorted production structure can be preserved. We have a choice: pay now or pay more later. The Obama administration came into office talking about a nearly $800 billion program, in addition to the $700 billion already available for bailouts and mortgage cleanup, to stimulate consumption. This presumably was in anticipation of a precipitous fall in consumption spending—reminiscent of the Great Depression of the 1930s—that was expected to result from massive capital losses produced by the financial and housing price meltdowns. As bad as things are now, we are as yet nowhere near the situation of the Great Depression, and one hopes we never will be.

Attempts to solve the crisis by simply providing more liquidity or "stimulating" the economy won't work. In fact they will make things worse by creating the illusion that the distorted production structure can be preserved.

This massive expansion of money is occurring at a time of great uncertainty. So the money is not circulating through the economy very rapidly (as people are reluctant to lend and even to borrow). The time will come, however, in the not-too-distant future when this excess liquidity will inevitably result in general price inflation and all the negative side effects that this always brings.

The stimulus package and the other varied and unpredictable government initiatives that we have witnessed recently—like the "bailout" of Citigroup and AIG—are unlikely to do any good at all, except for those who are directly subsidized by these actions at the taxpayers' expense. We know from the logic of basic economics and from history that such initiatives are unlikely to work. And we know that, at very best, they will postpone the necessary reallocation of resources that *must* take place before the economy can recover. Most likely they will seriously exacerbate the misallocation of resources and make the recovery ultimately more difficult.

What is most alarming to me personally is the enthusiastic recycling—indeed apparent wholesale resuscitation—of discredited Keynesian ideas. The false prophet of the public purse is back.

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A Microeconomist's Protest

BY MARIO J. RIZZO

The Keynesian worldview seems to have led to increasing stridency and dogmatism about economic stimulus, which has dominated the headlines for several months. There used to be a joke that you can teach a parrot economics—all it needs to say is "supply and demand." Now it is even easier to teach a parrot the policy prescription to prevent a major recession: All it needs to say is "stimulus."

Things have gotten so bad that no dissention can be tolerated. The German Chancellor Angela Merkel was harshly criticized for not going along, at least to the requisite degree, with the stimulus consensus. She stood out as "Frau Nein" until she went along with a "moderate" package.

I am not a macroeconomist. I am not even a financial economist. So much of my reaction to the current financial and economic problem may seem out of step with what most commentators are saying. Yet I think it is important.

Parrot photo courtesy Emmanuel Keller

Collective Irrationality

The macroeconomic frame of mind is quite peculiar. In the name of the emergency, this way of thinking dismisses most concerns about the efficient allocation of resources and throws almost total emphasis on maintaining levels of expenditure and employment. The implicit assumption is that the central problem is a collective irrationality that inhibits people from spending on consumption or investment. The root of the central problem, conceived in this way, is the initial financial meltdown. This involved a kind of domino effect in which the collapse of the housing market and of mortgage-backed securities, packaged in many complex ways, undermined the liquidity and even solvency of many financial institutions. The system's ability to provide credit and thus expenditure was compromised, although at this writing the reduction in bank credit available has been relatively small.

Thus the solution, we are told, lies in returning to the status quo ante. Restore the condition of the financial institutions—perhaps by buying toxic assets or perhaps by infusing capital into the institutions. Restore the conditions of the housing market by getting the Fed and/or Treasury to buy Fannie and Freddie mortgage securities, thus sending capital into housing and lowering mortgage rates. Restore the condition of industries with large numbers of employees and others indirectly

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dependent on them. (So far, the automobile industry qualifies.) In general, restore the pattern of expenditure that prevailed before the crisis.

I realize that no economist believes that complete restoration to the previous situation is possible, but the basic philosophy is clear. Once economic agents believe something like this will take place, confidence will be restored.

The critical issue is this: Has the current situation—triggered by unsustainable levels of mortgage credit and production in the housing industry as well as in other interest-rate-sensitive areas—gone so far beyond its cause that we no longer need to worry about these previous misallocations of capital? In other words, *is the correction of the cause now irrelevant to the cure?*

Stimulus ex Machina

To discover the answer to this question, let's step back a bit. We must understand the respective roles of causes and feedback effects. This is the "Keynesian" argument. Suppose a fall or collapse in markets *X*, *Y*, and *Z* causes *F* (a financial meltdown). Then *F* itself causes *X*, *Y*, and *Z* to fall further. Some of this is deleveraging, and some is the result of falling confidence in, say, the creditworthiness of counterparties. There is a general lack of clarity about what resources and financial instruments are worth. The future begins to look radically uncertain rather than simply risky. A collapse of confidence thus contributes to a fall in production and employment in areas far removed from the initial bubble-burst. The process is not dampening but explosive in the absence of the *deus ex machina*—that is, fiscal or monetary intervention.

Now let us imagine a cure that ignores the original misdirection of resources to the degree that it treats the collapse in these markets as mainly due to some exogenous loss of confidence. The Federal Reserve decides, as it actually has, to buy mortgage-backed securities, causing credit to become available in the housing market at lower interest rates. This also causes the prices of homes to stop falling and to begin rising. When will the Fed stop this infusion of newly created money, and hence a relative rise in resources, into the housing market? Presumably it *should* stop when the sector is brought back to a level that is simply a correction of the previous excess. In other words, the Fed should prevent the additional, "irrational" decline due to "feedback" effects.

> The conventional macroeconomic diagnosis and proposed cures ignore many important structural or microeconomic factors.

Where is the feedback-sanitized point? I doubt anyone knows. Consider what it means to know. The planners would have to know the *array* of housing prices corresponding to the normal fundamentals of the housing market. This would be the prices that prevailed when the market was not overexpanded. However, it would not correspond simply to the average of recent values because the housing market has been overexpanded for so long. Recently, two economists have attempted to estimate these prices. ("First, Let's Stabilize Home Prices," by R. Glenn Hubbard and Chris Mayer, *Wall Street Journal*, Oct. 2, 2008.) Unfortunately their attempt is marred by the same extrapolation of historical experience that seems to have gone terribly wrong in the assessment of the risk associated with derivatives and mortgage-backed securities. More importantly, however, it seeks to determine normal market prices in the absence of a freely functioning market.

Suppose, however, the Fed is realistic and admits it doesn't know. It will then simply try to get the housing market (and other similar interest-sensitive markets) to such a point where *general* production and employment are considered non-recessionary. The standard, practically speaking, will be the status quo ante. This is because of the lack of theoretical-empirical guidance discussed above and because the various sectors, bolstered by various politically powerful pressure groups, will not be satisfied until they are made whole. At this stage we would be left with the unsustainable direction of resources more or less back in place. The direction is unsustainable because, as the original bubble revealed, it was not consistent with the preferences of consumer-saver-investors.

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Why it Won't Work

Therefore the conventional macroeconomic diagnosis and proposed cures ignore many important structural or microeconomic factors, including the following:

1. The "irrationality" is not primarily in the system's response to the initial financial impulse but in the unsustainable expansion of the housing and other capital markets in the first place. Proposals to prop up the housing market as if its contraction is some kind of unfortunate overreaction are not credible. Too many resources went into the housing market due to the low-interest-rate policy the Fed followed for too long. While housing prices have fallen recently in many markets, they need to fall further. Markets should be allowed to equilibrate.

2. Equilibrium in the housing market would provide greater transparency to the value of mortgage-backed securities. Lack of certainty about housing prices and the ultimate extent of foreclosures only adds to the problems surrounding the illiquidity of these securities.

3. Government infusion of capital with the purpose of restoring the status quo ante ignores the facts: Fannie and Freddie were overexpanded, the domestic automobile industry is a destroyer of scarce capital, some financial firms did a poor job of allocating risk, banks extended loans under the pressure of the government to people who should not own homes, and so forth. Resources were misallocated.

Confidence Follows Correction

Recessions are not simply crises of confidence or of insufficient demand (due to increases in the demand to hold money). They also have their allocational—or microeconomic—aspects. I suggest that these systemic distortions have an important role in creating the aggregate phenomena we are witnessing. To treat these distortions and their cure as relatively unimportant is a mistake. Lasting investor and consumer confidence follows the correction of the underlying causative distortions and does not precede them. In fact, the dominant macroeconomic policy framework does not leave room for correcting distortions at all because its basic theme is to restore, prop up, and maintain the current direction of resources.

The hastily approved macroeconomic schemes of the Bush and Obama administrations will not succeed in promoting lasting recovery because they ignore the microeconomic fundamentals. The direction of spending and hence resource allocation they generate are fragile—they are not consistent with the preferences of consumers, savers, and investors. Therefore, once the putatively temporary stimulus is complete, the corrective forces that are now trying to undo previous resource misallocations will reassert themselves.

Recessions are not simply crises of confidence or of insufficient demand. They also have their microeconomic aspects.

In the longer term, the threat of significant inflation looms large. After the U.S. Treasury has incurred the additional trillions of dollars in national debt (at least one trillion in George W. Bush's response to the crisis and a minimum of one more in Obama's response) and the Federal Reserve has completed expanding its balance sheet (thus creating new money) by some trillion or more, what will happen? Will the federal government abolish the stimulus programs, raise taxes to pay off the increases in the national debt (or even to service the debt), and cut entitlement programs? The constituencies that will be formed by the stimulus spending will resist. Will the Fed begin a contractionary monetary policy to absorb all the excess money it created in the name of the emergency? That would raise interest rates and the cost of servicing the huge national debt. What is probable is that we will see an effective repudiation of part of the national debt through inflation. The temptation will be all but irresistible to inflate ourselves out of this mess. The economic consequences of the "cure" will be worse than the disease.

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On the Austrian Theory of the Trade Cycle, Part II

BY DONALD J. BOUDREAUX

In my previous column I reported that the sustained and substantial economic growth over the past several decades caused me to question the empirical strength of the Austrian theory of boom and bust. According to that theory, the continued injection of fiat money into the economy should have led to excessive, unsustainable investments—investments that would inevitably turn sour. Some asset prices would crash, sending a harsh but necessary market signal that those investments were unwarranted. The result would be a recession as entrepreneurs reworked their production plans.

Since the early 1980s, however, no significant recession emerged.

Why not? The logic of the Austrian theory seemed sound. People *do* respond to changes in relative money prices, including interest rates. And whenever such changes are caused by money manipulation (rather than by changes in underlying economic reality), resources are certain to be channeled into activities that are economically inappropriate.

My curiosity about the apparent disconnect between empirical reality and the predictions of the Austrian theory intensified in recent years, spurred on by conversations I've had with a handful of Austrian-minded friends, each of whom disagreed with my claims that the economy has been growing and prosperity increasing. "Look," they'd say, "much of this prosperity isn't real! It's an illusion created by excessive money growth that gives rise to malinvestments. We'll have to pay too high a price for this 'prosperity' when it comes crashing down in the future."

Everyday evidence of greater prosperity—better cars, faster microchips, greater varieties of offerings in supermarkets, less-expensive and higher-quality clothing—combined with the long period (nearly 30 years) over which such evidence built up, convinced me that this prosperity was real. It was no illusion.

So I began to speculate that capital goods are more flexible than Austrian theorists assume them to be. A machine designed, say, to help build automobiles might be rather easily converted into one that helps build motorcycles or even mattresses—so easily converted that little economic disruption occurs as a result. Sure, money injections divert the economy from its ideal path, but many of the less-than-ideal paths that it can find itself on probably are not so very different from the ideal. Or at least these less-than-ideal paths are nevertheless ones that generate perceived net improvements in living standards over time.

Everyday evidence of greater prosperity, combined with the long period over which such evidence built up, convinced me that this prosperity was real. It was no illusion.

I did not formulate my hypothesis in any formal way. Nor did I subject it to empirical testing or to other economists for critical feedback. I was just beginning to think seriously along these lines when 2008 dawned—and with this *annus horribilis*, the scariest financial meltdown of my lifetime. In November, the Dow Jones Industrial Average was down 43 percent from its all-time high, which it had reached only 13 months earlier.

That figure represents an enormous crash in asset prices. In addition, unemployment is rising, so workers are being shed from uses that are now proving to be unprofitable. The underlying economic reality is exert-

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ing itself, destroying a crust of bad investments that, we now know beyond doubt, had built up over the years.

Perhaps the Austrian theory is correct after all. Perhaps the appropriate length of time necessary for the boom-bust scenario to play out is much longer than I'd assumed it to be—not a few years but a few decades. And perhaps many of the outputs produced by the malinvested capital turn out, in their own way, to be genuine and positive additions to society's material prosperity—not additions compared to total output without any money manipulation, but compared to total output in a world in which no further investment at all took place. The best evidence that I've seen reveals that the Federal Reserve under the chairmanship of Alan Greenspan (and certainly under his successor, Ben Bernanke) was very loose with the money supply—a policy that, according to economist Lawrence H. White, fueled the recent real-estate boom that has now gone bust. Here's White writing on December 2, 2008, at *Cato Unbound*: "As calculated by the Federal Reserve Bank of St. Louis, the Fed from early 2001 until late 2006 pushed the actual federal funds rate well below the estimated rate that would have been consistent with targeting a 2 percent inflation rate for the PCE deflator. The gap was especially large—200 basis point or more—from mid-2003 to mid-2005. The excess credit thus created went heavily into real estate. From mid-2003 to mid-2007, while the dollar volume of final sales of goods and services was growing at a compounded rate of 5.9 percent per annum, real-estate loans at commercial banks were . . . growing at 12.26 percent. Credit-fueled demand both pushed up the sale prices of existing houses and encouraged the construction of new housing on undeveloped land. Because real estate is an especially long-lived asset, its market value is especially boosted by low interest rates. The housing sector thus exhibited a disproportionate share of the price inflation predicted by the Taylor Rule [the formula devised by economist John Taylor of Stanford University for estimating what federal funds rate would be consistent, conditional on current inflation and real income, with keeping the inflation rate at a chosen target]. (House prices are not, however, included in standard measures of price inflation.)"

> I'm not sure where recent events leave my assessment of the Austrian theory. But I am much more inclined now to find in it the empirical oomph that for so many years I thought it lacked.

I'm not sure where recent events—the economy's still-ongoing turmoil—leave my assessment of the Austrian theory. But I am much more inclined now to find in it the empirical *oomph* that for so many years I thought it lacked. FEE

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The Trouble With Keynes

BY ROGER W. GARRISON

The economics of John Maynard Keynes as taught to university sophomores for the last several decades is now nearly defunct in theory but not in practice. Keynes's 1936 book *The General Theory of Employment, Interest, and Money* portrayed the market as fundamentally unstable and touted government as the stabilizer. The stability that allegedly lay beyond the market's reach was to be supplied by the federal government's macroeconomic policymakers—the president (with guidance from his Council of Economic Advisers), the Congress, and the Federal Reserve.

The acceptance in the economics profession of fundamentalist Keynesianism peaked in the 1960s. In recent decades, enthusiasm for Keynes has waxed and waned as proponents have tried to get new ideas from the *General Theory* or to read their own ideas into it. And although the federal government has long since become a net supplier of macroeconomic instability, the institutions and policy tools that were fashioned to conform to the Keynesian vision have become an integral part of our economic and political environment.

A national income accounting system, devised with an eye to Keynesian theory, allowed statisticians to chart the changes in the macroeconomy. Dealing in terms of an economy-wide total, or aggregate, policy advisers tracked the production of goods and services bought by consumers, investors, and the government. Fiscal and monetary authorities were to spring into action whenever the economy's actual, or measured, total output, which was taken to reflect the demand side of markets, fell short of its potential output, which was estimated on the basis of the supply side. Cutting taxes would allow consumers and investors to spend more; government spending would add directly to the total; printing money or borrowing it would facilitate the opposing movements in the government's revenues and its expenditures.

> The New Economics of Keynes shifted the focus of attention from the market to the government, from economically justified changes in market pricing to politically justified changes in government spending.

A chronic insufficiency of aggregate demand, which implies that prices and wages are somehow stuck above their market-clearing levels, was believed to be the normal state of affairs. Why might there be such pricing problems on an economy-wide scale? What legislation and government institutions might be standing in the way of needed market adjustments? These questions were eclipsed by the more politically pressing question of how to augment demand so as to clear markets at existing prices. The New Economics of Keynes shifted the focus of attention from the market to the government, from eco-

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nomically justified changes in market pricing to politically justified changes in government spending.

Politicians still appeal to basic Keynesian notions to justify their interventionist schemes. The continued use of demand-management policies aimed at stimulating economic activity—spending newly printed or borrowed money during recessions and before elections—requires that we understand what Keynesian economics is all about and how it is flawed. Also, identifying the flaws at the sophomore level helps students to evaluate in their upper-level and graduate courses such modern modifications as Post-, Neo-, and New Keynesianism as well as some strands of Monetarism.

The extreme level of aggregation in Keynesian economics leaves the full range of choices and actions of individual buyers and sellers hopelessly obscured. Keynesian economics simply does not deal with supply and demand in the conventional sense of those terms. Instead, the entire private sector is analyzed in terms of only two categories of goods: consumption goods and investment goods. The patterns of prices within these two mammoth categories are simply dropped out of the picture. To make matters worse, the one relative price that is retained in this formulation—the relative value of consumer goods to investment goods as expressed by the interest rate—is assumed either not to function at all or to function perversely.

Keynesian theory implies an inherent instability in market economies. Thus the theory cannot possibly explain how a healthy market economy functions.

Keynes's Neglect of Scarcity

Pre-Keynesian economics, such as that of John Stuart Mill, as well as most contemporaneous theorizing, such as that by Ludwig von Mises and F. A. Hayek, emphasized the notion of scarcity, which implies a fundamental trade-off between producing consumption goods and producing investment goods. We can have more of one but only at the expense of the other. The construction of additional plant and equipment must be facilitated by increased savings—that is, by a decrease in *current* consumption. Such investment, of course, makes it possible for *future* consumption to increase. Identifying the market mechanisms that allocate resources over time is fundamental to our understanding of the market process in its capacity to tailor production decisions to consumption preferences. But as Hayek noted early on, the Keynesian aggregates serve to conceal these very mechanisms so essential to the intertemporal allocation of resources and hence to macroeconomic stability.

In Keynesian theory the long-established notion of a trade-off between consuming and investing is simply swept aside. Consistent with the assumed perversity of the price mechanism, the levels of consumption and investment activities are believed always to move in the *same* direction. More investment generates more income, which finances more consumption; more consumption stimulates more investment. This feature of Keynesian theory implies an inherent instability in market economies. Thus the theory cannot possibly explain how a healthy market economy functions—how the market process allows one kind of activity to be traded off against the other.

The "Multiplier-Accelerator" Theory

The inherent instability makes its textbook appearance as the interaction between the "multiplier," through which investment affects consumption, and the "accelerator," through which consumption affects investment. The multiplier effect is derived from the simple fact that one person's spending becomes another person's earnings, which, in turn, allows for further spending. Any increase in spending, then, whether originating from the private or public sector, gets multiplied through successive rounds of income earning and consumption spending.

The accelerator mechanism is a consequence of the durability of capital goods, such as plant and equipment. For instance, a stock of ten machines, each of which lasts ten years, can be maintained by purchasing one new machine each year. A slight but permanent increase in consumer demand for the output of the

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machines of, say, 10 percent, will justify maintaining a capital stock of eleven machines. The immediate result, then, will be an acceleration of current demand for new machines from one to two, an increase of 100 percent.

The multiplier-accelerator theory explains why consumption is increasing, given that investment is increasing, and why investment is increasing, given that consumption is increasing. But it is incapable of explaining what determines the actual levels of consumption and investment (except in terms of one another), why either should be increasing or decreasing, or how both can increase at the same time. Students are left with the general notion that the two magnitudes, investment and consumption, can feed on one another, in which case the economy is experiencing an economic expansion, or they can starve one another, in which case the economy is experiencing an economic contraction. That is, Keynesian theory explains how the multiplier-accelerator mechanism makes a good situation better or a bad situation worse, but it never explains why the situation should be good or bad in the first place.

Only at the two extremities in the level of economic activity is a change in direction of both consumption and investment sure to occur. After a long contraction, unemployment is pervasive and capital depreciation reaches critical levels. As production essential for capital replacement stimulates further economic activity, the macroeconomy begins to spiral upward. After a long expansion, the economy is bulging at the seams. Markets are glutted with both consumers' and producers' goods. As unsold inventories trigger production cutbacks and worker layoffs, the macroeconomy begins to spiral downward. Keynes held that the economy normally fluctuates well within these two extremes experiencing a general insufficiency—and an occasional supersufficiency—of aggregate demand.

Textbook Keynesianism

In the simplistic formulations of macroeconomic textbooks, investment is simply "given"; in Keynes's own formulation, the inclination of the business community to invest is governed by psychological factors as summarized by the colorful term "animal spirits." Keynes recognized that there are some "external factors" at work, such as foreign affairs, population growth, and technological discoveries. The market is envisioned, in effect, to be some sort of economic amplifier which converts relatively small changes in these external factors into wide swings of employment and output. This is the basic Keynesian vision.

Wage rates and prices are assumed either to be inflexible or to change in direct proportion to one another. In either case the real wage (W/P) is forever constant. The actual level of wages and prices is believed to be determined (again) by external factors—this time, trade unions and large corporations. If the real wage is too high, there will be unemployment on an economy-wide basis. There will be idle labor and idle resources of every kind. The opportunity cost of putting these resources back to work is nothing but forgone idleness, which is no cost at all. The assumed normalcy of massive resource idleness assures that the perennial problem of scarcity never comes into play. William H. Hutt and F. A. Hayek were justified in referring to Keynesian economics as the "theory of idle resources" and the "economics of abundance."

The assumed normalcy of massive resource idleness assures that the perennial problem of scarcity never comes up.

Textbook Keynesianism has a certain internal consistency or mathematical integrity about it. Given the assumptions that prices and wages do not properly adjust to market conditions—that is, the assumption that the price system does not work—then the Keynesian relationships among the macroeconomic aggregates come into play. Even the policy prescriptions seem to follow: If wages and prices do not adjust to the existing market conditions, then market conditions must be adjusted (by the fiscal and monetary authorities) to the externally determined prices and wages.

In the final analysis, however, Keynesian theory is a set of mutually reinforcing but jointly unsupportable

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propositions about how certain macroeconomic aggregates are related to one another. Keynesian policy is a set of self-justifying policy prescriptions. For instance, if the government is convinced that wages will not fall and is prepared to hire the unemployed, then unemployed workers will not be willing to accept a lower market wage, ensuring that wages, in fact, will not fall. Thus, while the intention of Keynesian policy is to stabilize the economy, the actual effect is to "Keynesianize" the economy. It causes the economy to behave in exactly the same perverse manner that is implied by the Keynesian assumptions. This convoluted interrelationship between theory and policy has long obscured the fundamental flaws in the theory itself.

Students often ask the obvious question: Why is government policy grounded in such a flawed theory? From a political point of view, advocating and implementing Keynesian policy is the surest way to election and reelection. The gains from printing and spending money are immediate, highly visible, and can be concentrated on individuals who make up powerful voting blocs. The costs of this policy are incurred at a later date and can be spread thinly across the entire population, making the link between policy and long-run consequences difficult for the voting public to perceive.

From a political point of view, advocating and implementing Keynesian policy is the surest way to election and reelection. Printing and spending money in pursuit of short-run stimulation if not long-run stability remain the order of the day.

The fading in recent years of old-line Keynesianism in academic circles provides little comfort. Even as the number of demand-managers continues to decline, it is from this shrinking group of economists that government officials seek advice and reconciliation. And opportunities to lecture to the seats of power rather than in the halls of learning have a way of changing some economists' minds about the advisability (political if not economic) of managing aggregate demand. Printing and spending money in pursuit of short-run stimulation if not long-run stability remain the order of the day.

There is good reason, then, to study Keynesian theory: It helps us understand what the policymakers in government are likely to do in any given circumstance. But to understand the actual effects of their demand-management policies in the long run as well as the short, we need a more enlightening theory—one that recognizes what market forces can do on their own to maintain macroeconomic stability and how those forces are foiled by government-supplied stabilization. FEE

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Too Big to Succeed

BY LESS ANTMAN

One widely cited culprit for the 2008 financial crisis was a supposed decision by the U.S. government not to regulate a relatively new type of financial instrument known as a credit default swap (CDS). In fact, this so-called "failure to regulate" refers to *regulations* that prohibited public trading of these instruments, concentrated risk in a small number of large firms, and massively increased the probability of a financial disaster. To add to the irony, one of the government officials most responsible for these interventions, then-Federal Reserve Chairman Alan Greenspan, recently apologized for having had too much faith in the free market when he should have apologized for not having had enough.

Brooksley Born, former head of the Commodity Futures Trading Commission.
Photo courtesy Arnold & Proter LLP

In 1999 Brooksley Born, head of the Commodity Futures Trading Commission (CFTC), tried to bring CDSs under the regulatory umbrella of her agency. Born was stymied by Greenspan, Treasury Secretary Robert Rubin, and Securities and Exchange Commission Chairman Arthur Levitt. She eventually resigned and the dispute was effectively settled in 2000 by the passage of the Commodity Futures Modernization Act (CFMA), which prohibited the CFTC from any further examination of CDSs. Details of the dispute can be found in an October 15, 2008 *Washington Post* article titled "What Went Wrong," by Anthony Faiola, Ellen Nakashima, and Jill Drew. But the article itself went wrong when it saw only deregulation and free markets in a fiasco caused by regulation and central planning. It failed to consider the full implications of the CFMA itself, nor did it address the disastrous side effects of an international agreement known as the Basel Accord, both of which made credit default swaps anything but a free-market failure.

Who's in Charge?

As neat and tidy as it might be to portray Born as the advocate of regulation and Greenspan, Rubin, and Levitt as opponents, it was actually a dispute among government officials over which of them should be in charge. The confusion derives from the nature of CDSs themselves.

When someone borrows money the lender is always concerned about the possibility that the borrower will not repay the loan. There are various ways for the lender to protect against that risk. The lender can sell the loan to someone else, who assumes both the right to collect the payments and the risk that the borrower will fail to make them. The lender can require the borrower to find someone willing to guarantee the loan—that is, someone who agrees to pay if the borrower defaults. Or the lender can make a separate contract with an unrelated third party who, in exchange for a premium paid by the lender, agrees to make the same guarantee to pay the lender if the borrower defaults.

A CDS is an example of the third option. The party paying the premium—the lender in this example—is considered the buyer of the CDS. The seller of the CDS is essentially providing default insurance, so a CDS can be viewed as an insurance contract and might be

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subject to regulation by government officials who oversee the insurance industry.

It is also, however, a form of derivative—a contract that derives its value from another asset or contract (in this case, the actual loan), but which can be settled separately by a payment of cash or some other highly liquid asset. In fact the parties to a CDS don't actually need to have any relation to the loan: You and I can enter into a CDS in which I pay you a premium and you promise to pay me money in the event General Motors defaults on bonds that neither you nor I own. In this case, you and I are both speculating (or gambling) on a possible future event and neither one of us can be described as insuring the other against risk. Thus a CDS may be viewed as a form of futures contract and might be subject to regulation by government officials who oversee the futures industry.

Many of the biggest players in the CDS market turned out to be banks. Only about 40 of the more than 5,000 banks in the United States traded CDS contracts, with three of them—J.P. Morgan Chase, Bank of America, and Citigroup—trading more of them than all other banks combined. Commercial banks ended up as major buyers of packages of loans known as mortgage-backed securities that were protected by credit default swaps, and many investment banks were involved in these transactions. Thus a CDS may be viewed as a product supporting banking and lending and might therefore be subject to regulation by government officials who oversee the banking industry.

Finally, since an overwhelming percentage of credit default swaps are associated with either publicly traded bonds or publicly traded mortgage-backed securities, a case could be made for classifying a CDS as a form of investment security, which might be subject to regulation by the government officials who oversee the securities industry.

Despite the *Post's* portrayal, Born may actually have come the closest to advocating a free-market policy. Although she was never able to get far enough to develop her ideas in detail, as head of the CFTC she likely would have had the authority to regulate CDS contracts that were traded on public commodity futures markets. The three men opposing her prevented these contracts from being publicly traded at all. As a result, credit default swaps could only be traded privately, keeping this market in the hands of a relatively small group of big players whose subsequent missteps might have been prevented or their impact minimized by such public trading.

Private Versus Public Trading

The distinction between private and public trading is important. Private contracts are those resulting from one party directly contacting another and negotiating a mutually acceptable agreement. While government courts claim jurisdiction over the enforcement of these contracts, the content of the contracts is generally up to the two parties.

The CFMA regulated public trading in the severest manner possible: It forbade it.

Starting with the Securities Act of 1933, however, the federal government defined certain financial transactions as public matters and claimed the authority to regulate or prohibit them. Any contract that results from advertising or general solicitation, any use of an exchange that makes it possible for buyers and sellers to be matched up without knowing each other, or even the mere fact that one of the parties is an individual with a net worth under $1 million and an annual net income under $200,000 can be sufficient to claim the contract is a public matter.

The Commodity Futures Modernization Act, by prohibiting the CFTC from regulating credit default swaps, prevented it from authorizing public trading of CDSs on futures exchanges. In other words, the CFMA regulated public trading in the severest manner possible: It forbade it.

With only private trading permitted, the general public was effectively excluded. Furthermore, remember that private contracts must result from direct negotiations and that there is a prohibition on providing any public information about them that might be deemed advertising or general solicitation. This provided an overwhelming edge to the biggest players who traded them the most, as the high costs of contacting potential

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counterparties, negotiating contracts individually, and compiling private information created enormous economies of scale. Thus the federal government didn't merely declare credit default swaps off-limits to the CFTC; it also effectively created a trading cartel for the largest banks, insurance companies, and hedge funds catering to wealthy investors.

Credit default swaps were invented by a team led by Blythe Masters of J.P. Morgan in 1997 as a tool for hedging the risk of default on loans. In a truly free market, regulated exclusively and severely by Messrs. Profit and Loss, she would today be hailed for this great invention. Prices are information, and the cost of a freely traded credit default swap provides a far better estimate of the risk on a debt instrument than the opinion of a credit rating agency that doesn't personally suffer from a default and expresses its opinion in the form of letters. The meaning of a AAA or BB rating is vague and debatable, while a CDS priced at 1.08 percent on an 8 percent bond indicates that it is the equivalent of a risk-free 6.92 percent bond.

The cost of a freely traded credit default swap provides a far better estimate of the risk on a debt instrument than the opinion of a credit rating agency that doesn't personally suffer from a default.

Furthermore, making the risk tradable would allow virtually all of us to choose, if we wished, to include small amounts of CDSs in our diversified investment portfolios. We could increase our personal investment returns modestly in exchange for sharing in a tiny portion of the total risk associated with lending. We wouldn't all need to become experts in them. Mutual funds could put together diversified portfolios of CDS contracts and develop track records to draw our investments, and asset managers would have the incentive to become more informed in order to serve clients better. As a personal financial adviser, I would love to have that option for the client portfolios I manage.

Finally, the widespread trading of CDS contracts would help minimize counterparty risk—the danger that the party with whom we've contracted will not honor his obligations. With many people able to trade them, the portion held by any one player could be reduced and those who overexposed themselves to risk would have a ready market to hedge their own activities.

How Government Made the CDS a WMD

Unfortunately, government intervention helped make credit default swaps toxic. The explosion in the use of CDSs was not a free-market phenomenon. In 1988 the Basel Committee on Banking Supervision, an international body made up of representatives from all the major central banks, produced the Basel Accord, which went into effect in 1992 in the United States and most other participating countries. The accord set capital requirements for all banks that weighted assets based on their risk. The Basel II Accord was signed in 2004 to refine the requirements.

Under the Basel Accords the lowest capital requirements for a bank were not for the loans they personally originated and understood best but for AAA-rated securities. The safest direct loans are home mortgage loans to borrowers with excellent credit whose loan amounts don't exceed 80 percent of the property value. These loans to "prime" borrowers have a risk weighting of 35 percent under Basel II. But if such loans are packaged into a mortgage-backed security rated AAA, the risk weighting is only 20 percent, reducing the amount of capital the bank must keep on hand and increasing its profits. Thus a bank has the incentive to sell the loans it has originated and replace them with AAA securities. Indeed, Basel II virtually mandated that banks sell their loans if they wanted to be competitive. The biggest buyers, Fannie Mae and Freddie Mac, two government-sponsored enterprises operating as profit-making businesses, benefited enormously from this regulation-inspired activity.

Not all loans are to prime borrowers with large down payments, however. Because of various government mandates, such as the Community Reinvestment

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Act, incentives were created to lend to less creditworthy borrowers with low or no down payments. Although most of these loans were not made by banks, they too were packaged into mortgage-backed securities, and many of them found their way to banks as AAA-rated securities.

How so? Why would a package of loans to subprime borrowers get the same high rating as a package of loans to prime borrowers? Through the magic of a CDS. Although the loans themselves might have a high risk of default they were protected by credit default swaps sold by entities that were themselves rated AAA, such as AIG Insurance, and CDSs were given AAA ratings as a result. A package of subprime loans might be rated BB (below investment grade), getting a prohibitive 350 percent risk weighting under Basel II, but that would be reduced to 20 percent weighting as a CDS-protected AAA security.

This was an international phenomenon. In September a report of the Center for European Policy Studies described the bailout of AIG Insurance by the Federal Reserve as a bailout of the European banking system. AIG was exposed to nearly a half-trillion dollars in credit default swaps, $300 billion of it to provide regulatory capital relief to European banks subject to Basel II. On September 15, 2008, the credit-rating agencies Standard & Poor's and Moody's downgraded AIG's debt rating. Ironically, the price of credit default swaps on AIG itself had been rising for months, demonstrating the superiority of CDS pricing to credit ratings in the timely identification of borrower difficulties. This triggered contractual obligations for AIG to post tens of billions in additional collateral to guarantee its own ability to perform on the CDS contracts it had sold. There was some evidence that AIG could have arranged financing through various hedge funds or American banks but it apparently didn't like the terms of these loans. It obtained a better deal from the Fed, even though the central bank has no oversight authority with respect to insurance companies. Had AIG not been able to post the additional collateral, the CDS protection it offered would no longer have preserved the AAA ratings of the securities in the European bank portfolios it was insuring, and capital requirements would have increased by as many as 16½ times for some of the assets held by these banks.

Jury Still Out

So how significant were credit default swaps in the financial meltdown of 2008? For the firms that went bankrupt, such as Lehman Brothers, or those that were taken over, such as Bear Stearns, or those that had to cede significant control in exchange for government bailouts, such as AIG, very. They were big players in the CDS market who made some bad bets and failed to hedge their own risks.

Credit default swaps didn't melt down at all. The market for them continued to function smoothly even as the traditional credit markets were struggling.

It is not nearly as clear that there is any systemic problem with credit default swaps. In a November 15, 2008 article, "The Meltdown That Wasn't," the *Wall Street Journal* noted, "Lehman Brothers was supposed to be exhibit A. The firm was on one end of roughly $5 trillion in CDS contracts, according to Moody's, and Lehman was itself the subject of $72 billion in CDS, in which other investors were betting on Lehman's success or failure. Here was the doomsday scenario, with a major player in CDS going bankrupt. It turned out to be the meltdown that never melted."

Lehman failed and the government let it fail. There is no evidence the liquidation had anything to do with problems for any other player. Businesses go bankrupt all the time, and it is best for the long-term health of an economy that incompetent managers cease to manage.

Credit default swaps didn't melt down at all. The market for them continued to function smoothly even as the traditional credit markets were struggling. There were many causes for the housing boom and bust that played the biggest role in the financial panic of 2008, and it is quite plausible to wonder if CDS contracts are being scapegoated to distract from other, more likely

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villains. The role of CDSs in satisfying regulatory capital requirements appears to have been a major reason for the explosion in their use. If there is any failure there, it is in the unforeseen consequences of the regulations that came from the Basel Accords. They should be modified or repealed.

The Born Supremacy

Still, had Born gotten her way in 1999, many good consequences might have come from it:

1) Publicly traded CDS contracts almost certainly would have priced the risk of various debt instruments more accurately than the credit-rating agencies have done. As mentioned, CDS prices showed AIG was in trouble before the rating agencies acknowledged it.

2) Large players in the CDS market would have had a convenient way to hedge excessive risk exposure without being limited to hedge funds, big banks, insurance companies, and the federal government.

3) The inefficiencies in pricing that have allowed players such as J.P. Morgan Chase to make large profits on the basis of superior information would have been replaced with a more efficient market and level playing field.

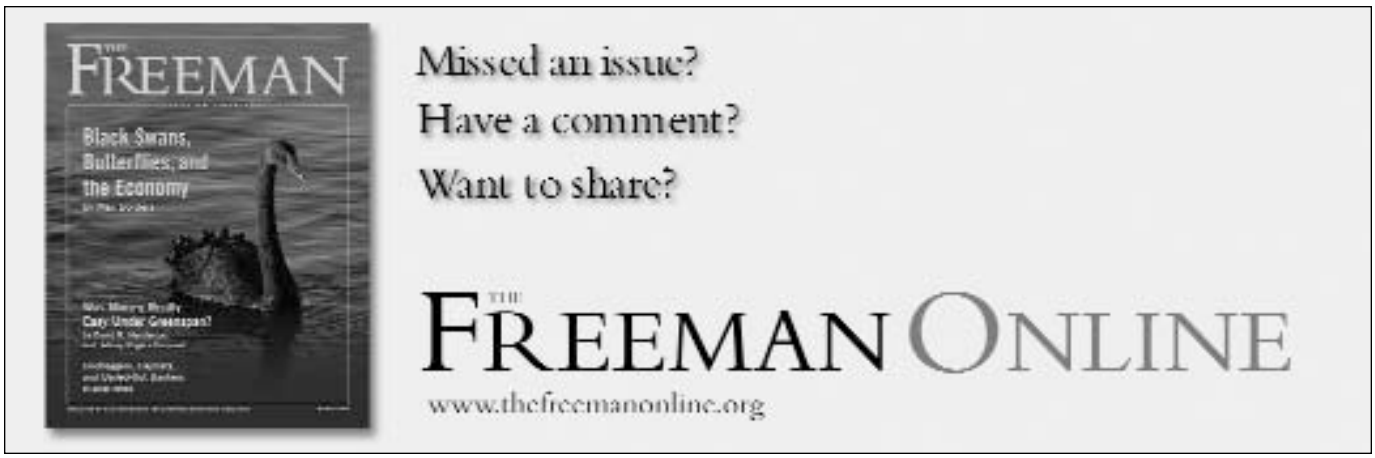
4) Individual investors would be able to diversify portfolios more and earn some of the returns available in this market instead of being available only as taxpayers to bail out the incompetent.

5) Counterparty risk would be massively reduced by the much greater number of participants in the market.

The role of CDSs in satisfying regulatory capital requirements appears to have been a major reason for the explosion in their use. If there is any failure there, it is in the unforeseen consequences of the regulations that came from the Basel Accords.

Born may be getting the last laugh. In October 2008 the Chicago Mercantile Exchange announced plans to establish exchange trading of credit default swaps. In spite of the posturing of some politicians there is enough recognition of the benefits of derivatives to ensure that the markets for them will be expanding rather than disappearing. While we can only hope exchange regulation will be limited to the enforcement of contracts, regulated public trading is better than none at all.

The democratization of credit default swaps has begun. Greenspan, Rubin, and Levitt may have meant well in trying to limit CDS trading to big players, figuring that the public wasn't ready to assume the risks associated with new financial instruments. Unfortunately the massive taxpayer-financed bailouts have shown that the public was going to bear the cost of failure in any event, and the primary result of their elitist attitude was to concentrate risk unnecessarily within a handful of firms whose exposure made them too big to succeed.



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Globalization: Extending the Market and Human Well-Being

BY GENNADY STOLYAROV II

Much of the prosperity of today's world arises from the division of labor. Globalization, by extending the market's scope to the entire world, enables the division of labor to become as developed as the current world population allows. However, to be truly in the interests of consumers and a boon to economic prosperity, globalization needs to occur spontaneously through the workings of the unhampered free market. Government attempts to meddle with this process—even with the sincere intent to facilitate or accelerate it—will only undermine its efficacy at benefiting us all.

In his 1776 classic, *The Wealth of Nations,* Adam Smith explained that "the division of labor is limited by the extent of the market." This is not hard to understand on an individual and local scale. Imagine you are somewhat skilled at making tables. If you live alone in a cabin in the woods and can only personally use the tables you make, you might create four or five of them—but there your need for them would stop. You would have little further reason to continually develop your table-making skills. You would not be able to turn table-making into your full-time occupation. After all, you also need food, shelter, non-table furniture, and myriad other goods to have even a meager standard of living. You would have to create all these goods yourself, with no time to develop anything beyond a rudimentary table-making ability.

If you have a few friends who also use tables, you can devote more of your time to making them and improving your craftsmanship, while exchanging the tables for other goods your friends specialize in producing. If you live in a village, your ability to obtain most of the goods you desire solely by producing tables increases along with your likelihood of finding enough people who demand tables to keep you busy during all of your working hours. As you sharpen your skills, you might even begin to incorporate artistic flourishes into your tables and learn how to make tables suited to specific purposes. Perhaps you might become a master craftsman of coffee tables or desks. In a large city, the demand for either of these types of tables alone might keep you employed.

> Globalization needs to occur spontaneously through the workings of the unhampered free market.

But imagine that your passion in life is to carve elaborate geometric designs into your tables and turn them into unique works of art. This kind of table-making takes many days of hard work, and only a few people in the world would appreciate the merits of your table art. You might be able to command a high price for each of your special tables—say, $10,000—if you could find a buyer. But let us say that only 60 people out of the world population of six billion would be willing buyers of one of your tables each year. In your large city, there are six million people, so your probability of finding even one buyer in your city would be a mere 0.06—giving you an

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expected annual income of $600 if you specialized in making your unique tables. But if you were able to access customers from all over the *world* easily, then you might fulfill all the existing demand for your work and thereby receive an annual income of $600,000. You can live lavishly by only serving the needs of 60 people—*if* your market extends to the entire world. If you could only sell in your city, you would likely never have made many of your special tables, leaving so much potential value uncreated.

Globalization is the process of the ever-increasing extension of markets, past national and even regional boundaries. Three principal factors drive globalization. First, improved transportation and communication technology enables previously formidable barriers of distance and geography to be overcome. Adam Smith remarked on the extent to which water transport facilitated the division of labor and consumers' ability to get more and better goods faster: "A broad-wheeled wagon, attended by two men, and drawn by eight horses, in about six weeks' time carries and brings back between London and Edinburgh near four ton weight of goods. In about the same time a ship navigated by six or eight men, and sailing between the ports of London and Leith, frequently carries and brings back two hundred ton weight of goods." In our age, air freight and the Internet can be added to the list of technologies facilitating the extent of the market.

People in globalizing markets extend respect for each other's customs rather than suspicion of them.
Eric Molina

The second factor facilitating globalization is the removal of government restrictions on trade. Tariffs, quotas, subsidies to domestic producers, and other trade barriers make it difficult for businesses located outside a country to compete with domestic producers based solely on the consumer-evaluated merits of their products. Such interventionist measures tax domestic consumers and foreign businesses and artificially inflate the incomes of some—though by far not all—domestic businesses. The favored businesses have reduced incentives to cut costs and increase product quality, since the government shields them from the most intense competition. In the long run this leads to poor products, widespread waste, organizational inefficiency, and consumer dissatisfaction. When government trade barriers are removed and no regulations are put in their place this burden is lifted from millions of consumers and producers, who are now able to extend the market to the degree desired by consumers. Since reaching a high point with the Smoot-Hawley Tariff Act of 1930, tariffs levied by the United States against imported goods have generally declined up to the present day. Tariffs and other protectionist policies in many other countries have been likewise reduced, especially from the 1980s onward.

Increased Tolerance and Respect

The third factor responsible for globalization is increased tolerance by people throughout the world for others of different national, ethnic, and cultural backgrounds. As trade among people begins to take place, it becomes easier for people to see one another in terms of the goods and services they offer, rather than in terms of negative stereotypes, hatreds, and fear of "the other." In a virtuous cycle, people in globalizing markets begin to extend increasing respect, understanding, and willingness to cooperate to those who are unlike them. A more cosmopolitan, individualistic outlook emerges: Each producer and consumer is judged on the basis of personal actions and merits, not circumstantial group identity. This in turn makes it much easier for people to engage in trade with still more others, unhindered by unwarranted negative preconceptions. The prevalence in the United States of Mexican food, Japanese automobiles and electronics, Chinese manufactured goods, South American fruits, and hundreds of thousands of other goods imported from virtually all parts of the world illustrates the seamless merger between economic and cultural exchange—a ubiquitous characteristic of globalization. Richard Cobden, perhaps the most outspoken free-trade advocate of the nineteenth

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century, saw this growth of tolerance as a desirable aim and outcome of the extension of trade: "The people of [France and England] must be brought into mutual dependence by the supply of each others' wants. There is no other way of counteracting the antagonism of language and race . . . and no other plan is worth a farthing."

More Variety

The benefits of globalization are manifold. Economists recognize that globalization lowers prices for a wide array of consumer goods, thereby making consumers better off in real terms. But increased product variety is another outcome, well documented by Christian Broda and David Weinstein in their 2006 *Quarterly Journal of Economics* paper, "Globalization and the Gains from Variety." Broda and Weinstein note that "in 1972 the US imported 74,667 varieties (i.e. 7,731 goods from an average of 9.7 countries) and in 2001 there were 259,215 varieties (16,390 goods from an average of 15.8 countries)." Some of these goods were already common in their regions of origin but have now been able to spread elsewhere and find willing consumers. The spread of other products was only made possible by the ability of their providers to find enough customers by extending their market to the entire world. In his essay "Spicing the Gains from Globalization with Product Variety," Neel Chamilall emphasizes "that consumers value this greater product variety for its own sake, on top of the lower prices that globalization also generates." A wider range of possible satisfactions is valued since the more kinds of products exist, the likelier a particular product is to fulfill the specific tastes of an individual consumer at any given moment.

Richard Cobden, perhaps the most outspoken free-trade advocate of the nineteenth century.

But globalization's extension of the market facilitates more than the production of greater numbers and varieties of material goods. The *intellectual* division of labor—as well as the opportunities for intellectual cooperation extending throughout the world—are also greatly magnified by globalization. In "Globalization: The Long-Run Big Picture," George Reisman explains that globalization brings about a "substantial increase in the number of highly intelligent, highly motivated individuals working in all of the branches of science, technology, and business. This will greatly accelerate the rate of scientific and technological progress and business innovation." Reisman observes that "one of the greatest of all gains that results from the division of labor is the ability of geniuses to devote their full time to activities representing the discovery and application of new knowledge." The broader the division of labor, the greater the likelihood that a creative genius in business, science, medicine, engineering, or another vital field will not personally need to manufacture most of the goods he desires. Moreover, the likelihood that he will find a market receptive to his own endeavors increases to the maximum extent if he can interact with anyone in the world.

When creative geniuses—or creative people in general—communicate with one another, exchange ideas, and build on one another's work, additional economies of scale emerge. Many creators relying on each other's utmost strengths can produce more discoveries, inventions, structures, and organizational innovations than the sum total produced by each creator working in complete isolation—just as the division of labor in the pin factories Adam Smith observed could raise the number of pins produced per worker by orders of magnitude. When national, geographic, and cultural boundaries no longer pose barriers to creators exchanging ideas and undertaking joint ventures, some of the greatest possible benefits to all humanity can be realized.

Raising Everyone's Standard of Living

If globalization proceeds unhampered, it will achieve, in Reisman's words, "the elevation of the productivity of labor and of living standards all across the globe to the level of the most advanced countries, and at the same time the radical improvement in productivity and living standards in what are today the most advanced countries." As everyone is enabled to participate in a truly global division of labor, its benefits will spread

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throughout the world—eradicating true poverty and much other human suffering in all areas where governments do not forcibly restrain their people from peaceful economic and cultural exchange.

But aside from staying out of globalization's way, governments cannot act efficaciously to promote or accelerate it. As George Washington is reputed to have said, "Government is not reason. It is not eloquence. Government is force; like fire it is a dangerous servant—and a fearful master." Government's entire modus operandi is force or the threat thereof. If the government promotes *anything* in an affirmative fashion, it can only do so through the use of force. Calling a particular exertion of government force a "free-trade agreement" or a "free-trade organization" does not alter its nature, and the facts attest to this. In "Can Trade Ever Harm a Country?" Robert P. Murphy comments on the NAFTA "free-trade agreement": "The NAFTA is over 1,000 pages, detailing all sorts of environmental and labor regulations and establishing supranational boards to rule on disputes. If NAFTA really did nothing but establish free trade, it would be the size of a postcard, and there would currently be no tariffs between Mexico and the US." It is true that NAFTA lowers some tariffs and lifts other trade restrictions, but the government's *affirmative* exertions in this agreement amount to regulating and intervening *more* in certain aspects of commerce by controlling thousands of tiny elements of production, employment, and property ownership that would otherwise have been left to individual choice. There is no clear way of determining that the "free-trade agreement" resulted in more freedom than would have existed otherwise.

If the government promotes anything in an affirmative fashion, it can only do so through the use of force. Calling a particular exertion of government force a "free-trade agreement" or a "free-trade organization" does not alter its nature.

International institutions devised by Western governments allegedly to promote deregulation and globalization have often achieved the opposite purpose. Much of the apparatus of the World Trade Organization (WTO) engages in the imposition of retaliatory tariffs on the products of countries whose governments are deemed uncooperative. From a free-market standpoint, this is a travesty. Because the *government* of a particular country has infringed on economic freedoms, must the *private individuals and businesses* of that country suffer further infringements of their freedoms as a result? Moreover, having tariffs imposed through the WTO merely legitimizes them and falsely assures many who would otherwise have opposed them that trade barriers are necessary somehow to bring about free trade.

Unilateral Action that Works

The only legitimate government policy regarding globalization is to *let the process develop* spontaneously through the interactions of billions of private individuals and to lift all trade restrictions *unilaterally.* Even if other governments have tremendous trade restrictions against American producers, and even if they completely prohibit imports into their countries, the U.S. government should permit all foreign goods to enter the country without at all taxing them, restricting their quantity, or regulating their quality.

The reasons for unilateral renunciation of all trade restrictions become clear once one considers that American consumers are subject to two distinct sources of harm. The first source is the trade barriers set up by other governments. But trade restrictions established by the *United States* government perpetrate even greater damage to American consumers, resulting directly in higher prices and lower quality. The presumption behind multilateral "free-trade agreements" has been that *only* foreign-imposed trade barriers hurt domestic consumers, while domestically imposed trade barriers are simply defensive or retaliatory measures. But if *both* foreign and domestic trade barriers hurt domestic consumers, then it is always preferable to have just one of these sources of harm—the foreign trade barriers—instead of both.

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The benefits of unilateral renunciation of trade restrictions do not stop at freeing consumers from domestically imposed tariffs, quotas, regulations, and subsidies. Such a course of government *inaction* sends an unambiguous message to foreign governments and businesses that we are willing to benefit from anything they have to offer us, while respecting them enough to let them operate as they see fit. This gesture of goodwill is likely to be reciprocated, just as Cobden's success in getting Britain to abolish the Corn Laws unilaterally in 1848 led multiple European countries to eliminate many of their own trade barriers.

The way to truly accelerate globalization is not to wait for all nations to agree warily to the conditional removal of restraints on their own people, but rather to boldly proceed alone in knocking down one domestic trade barrier after another. With the passage of time, it will become evident that not having retaliatory trade restrictions against the producers of other countries does *not* in fact harm American consumers or producers. Other governments, seeing the mercantilist fears falsified empirically, will become increasingly inclined to join in the rising prosperity by opening their markets to globalization. As globalization fosters a truly international division of labor, billions of people will come to benefit from unprecedented product variety, technological growth, and cultural exchange. FEE

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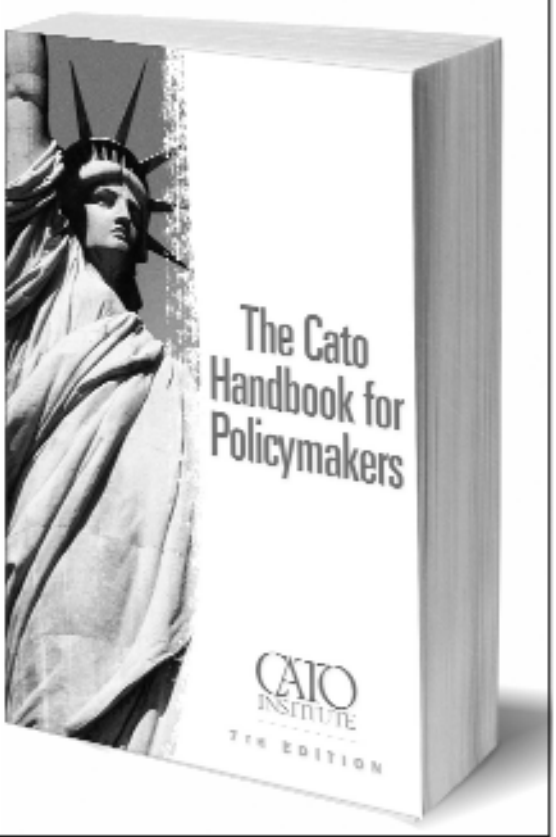

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The NRA: How Price-Fixing Perpetuated the Great Depression

BY BURTON FOLSOM, JR.

During the Great Depression of the 1930s the first thing to be sacrificed was free markets. Industrialists, farmers, laborers, and many more came to Washington for handouts, regulations, or price controls.

Some observers seem to think employers are less willing than employees to seek federal help, so the actual case is revealing. The National Industrial Recovery Act (soon shortened to NRA) became law under President Franklin Roosevelt in 1933 and dramatically altered America's traditional free-market system. Under the NRA, a majority of firms in any industry had government approval backed by force to determine how much a factory could expand, what wages had to be paid, the number of hours to be worked, and the prices of products. Whether or not a businessman helped write the code for his industry, he was bound by the terms and subject to a fine or jail term if he violated them.

The NRA let industries write wage and price codes, and jailed competitors who did not comply.

Evil Price-Cutting

Why were Roosevelt and certain New Dealers so eager for higher wages and prices without an increase in productivity and with less competition? They believed that if people earned more, they could buy more, and that would stimulate recovery from the Great Depression. In this high-wage theory the efficient, innovative, and price-cutting businessman was evil because he was believed to contribute to lower wages and therefore diminishing purchasing power. He was a violator of "fair competition." His gain was not just the loss of his competitors but of the whole country. By encouraging codes of "fair competition," the NRA was giving all existing businesses a chance to make profits, to pay high wages, and to survive the price-cutter.

Many businessmen liked the idea of raising their prices and sending to jail any competitor who wanted to charge lower prices. But such a move discouraged inventors and entrepreneurs from experimenting with ways to make products cheaper and better. The NRA in effect carved up markets among existing producers, fixed prices and wages, and assumed all industry was stagnant and unchanging. In automobiles, however, Henry Ford had experimented with assembly-line production and had cut the price of American cars from about $3,000 to $300. Under the NRA he was not allowed to innovate further. So Ford refused to sign the code and jack up his car prices, as his competitors at General Motors and Chrysler were doing. "I do not think that this country is ready to be treated like Russia for awhile," Ford wrote in his notebook. "There is a lot of that pioneer spirit here yet."

Ford was told his company would receive no government contracts until he signed—and with the large increase in government agencies during the 1930s, that meant a huge loss of business. For example, the government rejected a Ford agency bid on 500 trucks for the Civilian Conservation Corps that was $169,000 below the next best offer. "We have got to eliminate the purchase of Ford cars [by the government because the company has not] gone along with the general [NRA] agreement," Roosevelt said at a press conference.

Ford's assertion of freedom and independence gave hope to those who wanted to return to competition.

When Hugh Johnson, the head of the NRA, was asked what would happen to those "who won't go

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along with the new code," he threatened, "They'll get a sock in the nose." Although Johnson refrained from applying his fist to Ford's nose, he did use the arm of the law to jail many men who refused to jeopardize their businesses by complying with NRA codes. In York, Pennsylvania, for example, Fred Perkins, who produced storage batteries to help light farms, went to jail for paying his employees less than what had been written into the NRA code by the storage-battery businessmen. Perkins's employees were outraged that their boss was in jail, and they met with him to receive instructions on how to continue the business in his absence. As J.B. Jones, one of Perkins's employees, said, "We asked him for work and he gave it to us at a time when we were in distress. The wages he was paying were fair."

A more dramatic jailing was that of 49-year-old Jacob Maged of Jersey City, New Jersey. Maged had been pressing pants for 22 years, and his low prices and quality work had kept him competitive with larger tailor shops in the better parts of town. The NRA Cleaners and Dyers Code demanded that he charge 40 cents to press a suit. Maged, despite repeated warnings, insisted on charging his customers only 35 cents. "You can't tell me how to run my business," he insisted.

Not only was Maged thrown in jail, he was also slapped with a $100 fine. "We think that this is the only way to enforce the NRA," said Abraham Traube, a director of the NRA code authority for the Cleaners and Dyers Board of Trade. "If we did the same thing in New York City we would soon get the whole industry in line." Many editorialists, however, sided with Maged. "It didn't matter," the *Washington Post* said, "if Maged had to charge less than the bright and shiny tailor shop up the street if he wanted to continue to exist. The law said he couldn't." "For a parallel," the *New York Herald Tribune* said, "it is necessary to go to the Fascist or Communist states of Europe."

No merchants wanted to pay fines or go to jail, but the more than 500 NRA codes often imposed such quirky regulations that it was hard for many to comply.

Embarrassing Questions

No merchants wanted to pay fines or go to jail, but the more than 500 NRA codes often imposed such quirky regulations that it was hard for many to comply. Finally, in 1935, the Schechter brothers, who sold kosher chickens in Brooklyn, took their case to the Supreme Court to challenge the constitutionality of the NRA. Justice George Sutherland asked so many embarrassing questions about the NRA chicken code that the audience actually broke into laughter at some of the exchanges. By a 9-0 vote the NRA was found unconstitutional.

The defeat of the NRA was a cause for celebration. "The Constitution has been re-established," rejoiced Senator William Borah of Idaho. "Impulsively adopted . . . ," journalist Frank Kent said, "it [the NRA] was fastened on the people by the most blatant ballyhoo ever promoted by a Government, and it ends in a horrible mess." President Roosevelt disagreed and said the Supreme Court was taking the country backward with a "horse and buggy" interpretation of the clause in the Constitution that gives Congress the power to regulate commerce. Roosevelt's desire to continue his experiments in central planning and government intervention would keep the Great Depression going for many years more. When we freed up the American economy after World War II, however, we encouraged competition, innovation, and the creation of new jobs. The Great Depression was over at last. FEE

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Somalia: Failed State, Economic Success?

BY BENJAMIN POWELL

Perhaps the title overstates the situation slightly. It is hard to call any country mired in poverty an economic success. Yet by most measures Somalia's poverty is diminishing and Somalia has improved living standards faster than the average sub-Saharan African country since the early 1990s. In that sense Somalia is at least a relative success story. The most interesting part of Somalia's success is that it has all been achieved while the country has lacked any effective central government.

For many, the "A" word—anarchy—conjures up notions of chaos. For others it simply means the absence of a single government ruling a geographic area. In this second sense, Somalia has been in a state of anarchy since the fall of Siad Barre's dictatorship in 1991. The result has been, in general, economic development rather than chaos—although there certainly have been chaotic periods. The interesting questions are how has development been promoted and what has caused the chaos.

By most measures Somalia has improved living standards faster than the average sub-Saharan African country since the early 1990s.
Photo copyright Julian Rademeyer

Somalia, located on the eastern horn of Africa, gained independence from Italy and Great Britain in 1960. A democracy was initially established but it was overthrown in a military coup in 1969, when General Barre was installed as dictator. He ruled until his government was overthrown in 1991. Since the fall of Barre's government there have been multiple attempts to establish a new central government, but Somalia has remained an essentially stateless society.

Immediately after the central government collapsed the chaos many would have predicted came about. Rival warlords plunged the country into civil war as each attempted to install himself as the new head of state. During this period the famous "Black Hawk Down" incident, preserved in novel and movie, occurred. Eighteen U.S. soldiers and more than 1,000 Somali died in a violent conflict that followed U.S. and U.N. intervention. The foreign forces eventually withdrew in 1995.

With the withdrawal of U.N. forces the immediate prospect for installing a new government diminished—and with it so did the fighting. Somalia's entire experience with formal government has been one of plunder and resource extraction by the ruling elite. As long as there was a prospect for a new government, each clan had a strong incentive to fight to make sure it was on the receiving, rather than giving, end of the plundering. Once there was no longer the

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immediate prospect for a new central government the clans began to settle back into their traditional customary and mostly peaceful relationships with one another.

Each period of violent chaos in Somalia has generally centered around outside attempts to establish a new government inside Somalia. The most recent of these, which is still going on, is the Ethiopian-backed Transitional Federal Government (TFG), which entered Somalia in 2006. Opposition to the TFG bolstered support for the Islamic Courts Union (ICU), which itself became a de facto government in some areas of southern Somalia, including the former capital, Mogadishu. In December 2006 Ethiopia invaded and overthrew the ICU and installed the TFG in the former capital. However, there is little popular support for the TFG. Its control is weak and there are frequent decentralized attacks against TFG officials and soldiers and their Ethiopian supporters. It remains to be seen whether the TFG will gain greater control over the country or if clan factions and warlords will overthrow it.

From the U.N. withdrawal in 1995 until Ethiopa's invasion, Somalia did have some violent crime, but nowhere near the level that existed during its civil wars. In fact the Somali were able to maintain a functioning customary legal system that not only provided law and order but also formed the institutional foundation that enabled them to achieve greater rates of economic development than they achieved while they had a state and greater rates than many of their African neighbors.

Each period of violent chaos in Somalia has generally centered around outside attempts to establish a new government inside Somalia.

Customary Law in Somalia

Somali law is based on custom interpreted and enforced by decentralized clan networks. The Somali customary law, Xeer, has existed since pre-colonial times and continued to operate under colonial rule. The Somali nation-state tried to replace the Xeer with government legislation and enforcement. However, in rural areas and border regions where the Somali government lacked firm control, people continued to apply the common law. When the Somali state collapsed, much of the population returned to their traditional legal system.

The Xeer outlaws homicide, assault, torture, battery, rape, accidental wounding, kidnapping, abduction, robbery, burglary, theft, arson, extortion, fraud, and property damage. The legal system focuses on the restitution of victims not the punishment of criminals. For violations of the law, maximum compensation to victims is specified in camels (though payment can be made in equivalent monetary value). Typical compensation to the family of a murder victim is 100 camels for a man and 50 for a woman; an animal thief usually must return two animals for every one he stole.

Clan elders chosen on the basis of their knowledge of the law judge cases. The elders cannot create the law. They only interpret the community customs. Elders who make decisions that deviate from community norms are not consulted in future cases. When a dispute arises between two members of different clans, their clan elders must reach a compromise. If they are unable to do so they appoint an elder from another clan to settle the dispute.

After a verdict is reached the criminal must compensate his victim the appropriate amount. If he is unable or unwilling, his extended family must pay the compensation. Every Somali is born into an insurance group based on his lineage to a common great-grandfather. Out of their own self-interest these insurance groups help enforce the judgment on wrongdoers. When an individual becomes particularly troublesome a family can publicly declare that he is no longer a member, effectively making the person an outlaw. Outlaws must find another insurance group willing to sponsor them, or they are expelled from the larger clan. In cases in which more formal enforcement of the law is necessary, clan elders can call for all clansmen to form a posse to enforce the verdict; clansmen are obligated to answer the call.

Since Somali courts are independent of one another, they often interpret customary law differently. Within

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clans, differences of interpretation are usually quickly resolved, but this process can take much longer on the national level. Ultimately, through the resolution of disputes the law is discovered and conflicts in interpretation are resolved. Although the interpretation of the law stems from clan elders, the clans are not de facto governments.

Throughout Somalia individuals are free to choose new insurance groups and elders on becoming adults. They are allowed either to form a new insurance group with themselves as head or join an established group, if it accepts them. Movement between clans is particularly widespread in southern Somalia: Some clans have more adopted members than native-born members.

The individual clans and insurance groups are not geographic monopolies. Geographic distribution of clans does not match territorial boundaries. As pastoral Somali move throughout their country, their legal system moves with them. So in any given area multiple clan governance systems can exist.

While local cleric courts became the dominant source of law in some regions, and Qur'anic law is traditionally applied to marriage and inheritance, the common law of Xeer and the accompanying elder dispute resolution and insurance groups are the main source of law in Somalia. The Xeer shares a focus on restitution and the protection of life and property with English common law and other polycentric systems. The traditional Somali legal system existed unofficially during the reign of Siad Barre and since the collapse of the state it has emerged to provide some level of the rule of law on which coordination in the Somali economy could be based.

Economic Performance

There is no doubt that Somalia remains extremely poor today. However, as far as living standards can be assessed, they appear to be improving since the collapse of Somalia's national government. In fact, standards are improving faster in Somalia than in most of sub-Saharan Africa.

In other research my coauthors and I used the *World Development Indicators* to compare Somalia's performance with 41 other sub-Saharan African countries in both the current period and, when data allow, over time. All data from Africa—and perhaps Somalia in particular—should be treated with caution. But our findings are broadly consistent with the improvements other ethnographic and anthropological evidence has found.

Unfortunately, using a broad cross section of countries over a 20-year period for a region with often unreliable (or uncollected) data limits our metrics of comparison. We examined 13 measures: the death rate, infant mortality, life expectancy, child malnutrition, telephone mainlines, mobile phones, Internet users per 1,000 population, households with television, DPT immunization, measles immunization, percent of the population with access to sanitation and an improved water source, and cases of tuberculosis.

Although Somalia's 2005 standard of living was low by western standards, it compared fairly favorably with other African nations.

Although Somalia's 2005 standard of living was low by western standards, it compared fairly favorably with other African nations. Of our 13 measures, Somalia ranked in the top 50 percent of nations in five and only ranked near the bottom in infant mortality, immunization rates, and access to improved water sources. Although in 2005 the nation placed in the bottom 50 percent of countries on seven measures, it has actually improved performance relative to other countries since the collapse of the Somali state. Somalia ranked in the bottom 50 percent of all seven variables for which we have 1985-1990 data. In the last years of the Somali nation-state (1985-1990), its performance relative to other African countries deteriorated from the early 1980s, with Somalia losing ground in life expectancy, death rate, and infant mortality as well as DPT and measles immunization. Only telephone landlines showed a slight improvement during this time.

Life expectancy in Somalia fell by two years from 1985 to 1990, but it has increased by five years since becoming stateless. Only three of the 42 countries improved life expectancy as much since 1990.

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While Somalia's infant mortality ranking has continued to slide, its death rate has improved, jumping from 37th to 17th since 1990. While still in the bottom 50 percent in cases of tuberculosis, Somalia's relative rank has improved from 40th to 31st since the collapse of the government. Although Somalia's immunization rates for measles and DPT are among the lowest in Africa, its problems in this area existed before the collapse of the state. During the last five years of government rule Somalia's immunization rankings fell from 19th and 21st, respectively, to next to last in both categories. While the country has stayed near the bottom of this ranking, the percentage of children immunized has improved.

Access to improved water sources is a problem in Somalia. It ranks considerably better in access to improved sanitation facilities. Unfortunately, neither of these measures was available over a long enough time period to compare performance before the collapse of the state.

Telecommunications is a major area of success in Somalia. The one measure for which we have complete data, telephone landlines per 1,000 of population, shows dramatic relative improvement since Somalia became stateless, moving from 29th to eighth among the African countries included in our survey. It ranks high in mobile phones (16th) and Internet users (11th), while it ranks 27th in households with televisions.

In Somalia it takes just three days for a landline to be installed; in neighboring Kenya waiting lists are many years long.

In many African countries state monopolies and licensing restrictions raise prices and slow the spread of telecommunications. In Somalia it takes just three days for a landline to be installed; in neighboring Kenya waiting lists are many years long. Once lines are installed, prices are relatively low. A $10 monthly fee gets a customer unlimited local calls, and international calls are only 50 cents per minute. Web access costs only 50 cents an hour. According to *The Economist*, using a mobile phone in Somalia is "generally cheaper and clearer than a call from anywhere else in Africa."

We also compared Somalia to a subset of African countries that have been peaceful to make sure that it was not wars in other countries that account for Somalia's relative improvement. We found basically the same results.

Although the data should be treated with caution, our findings are consistent with the evidence showing the rural pastoral sector growing and an increasing willingness of international businesses to open up in Somalia. Unfortunately there is one new international "business" in Somalia that has many observers concerned—piracy.

What About the Pirates?

Piracy has been on the rise in Somalia over the past year. In fact, if you have heard about Somalia in the news recently, it is likely because of the piracy. Some Somali have organized themselves into pirate bands that use small craft to raid large foreign ships passing by the country. They often hijack the cargo and crew and demand ransom. Somali pirates have attacked more than 100 ships in the last year. As of December they were still holding 17 ships with approximately 300 crew members for ransom. Estimates indicate that these pirates were paid nearly $30 million in ransom over the last year.

Because of Somalia's strategic location at the entry to the Red Sea and Suez Canal, the Somali pirates are becoming an increasing international concern. The already well-armed pirates have used some of their profits to invest in more sophisticated weaponry, making themselves an even greater threat.

Although they are a concern, this is not merely a symptom of a "failed state," as many media reports make it out to be. In one sense, that the piracy is committed against passing foreign vessels is a tribute to the internal effectiveness of Somali customary law. The pirates are well-armed and obviously not hesitant to use violence. Yet they do not plunder Somali ships. What's more, they interact peacefully with other Somali when they are on land. Although the total number of pirates is small, it has been estimated that 10,000 to 15,000 people are employed by the pirates indirectly in related industries such as boat repair, security, and food provi-

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sion. (Other enterprising Somalis have set up special restaurants to cater to the hostages.) That pirates use voluntary market transactions to purchase goods and services on land, rather than pillage, provides some evidence that Somali law is fairly robust if even these otherwise violent people respect it when conducting their internal affairs.

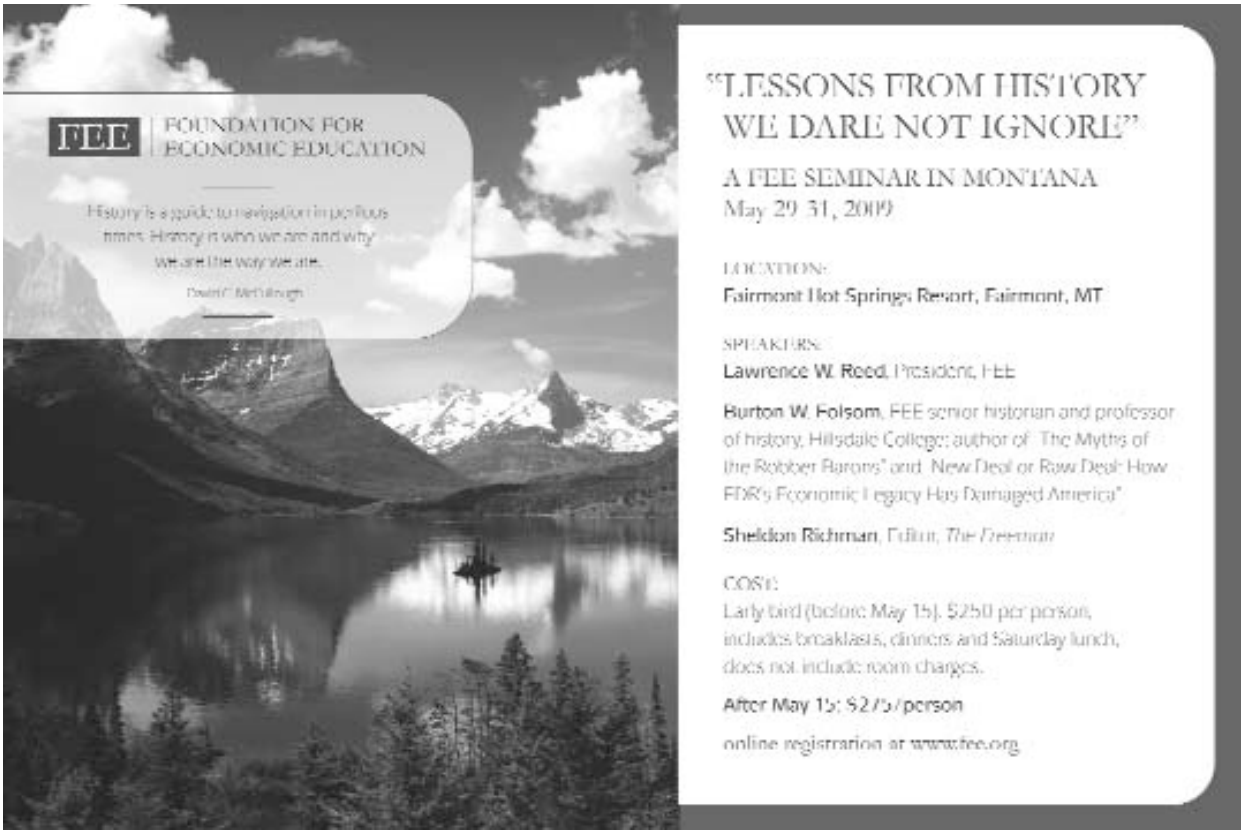
Somalia's pirates are criminals, of course, but the nonpirate Somali are not and should not be subject to retribution, including the imposition of an internationally "friendly" government, for the criminal acts of a few.

Instead, Somali pirates should be dealt with like any other violent criminals. Those responsible for crimes should be punished and stopped from committing future acts of piracy. This is probably best accomplished by armed ships protecting shipping lanes, not an internationally backed invasion or sponsoring of a new Somali government. Any government sponsored in Somalia would likely prey on the population just as Siad Barre's regime did. Such predation would likely result in many more criminal acts with far worse consequences than anything done by the pirates.

Somalia's Lesson

Somalia's lesson should not be overstated—it is no libertarian utopia. I certainly don't plan to move there anytime soon. But Somalia does demonstrate that a reasonable level of law and order can be provided by nonstate customary legal systems and that such systems are capable of providing some basis for economic development. This is particularly true when the alternative is not a limited government but instead a particularly brutal and repressive government such as Somalia had and is likely to have again if a government is reestablished.

Economist George Ayittey often refers to many African governments as "vampire states," which suck the lifeblood out of their citizens and their economy. He recently wrote that the "rogue African nation-state should be left to the fate it deserves—implosion and state collapse." Many would react with horror to such a suggestion and say, "If that happened you'd end up with another Somalia!" The lesson we should learn from Somalia is that that's not so bad—at least when compared to the often ghastly alternatives. FEE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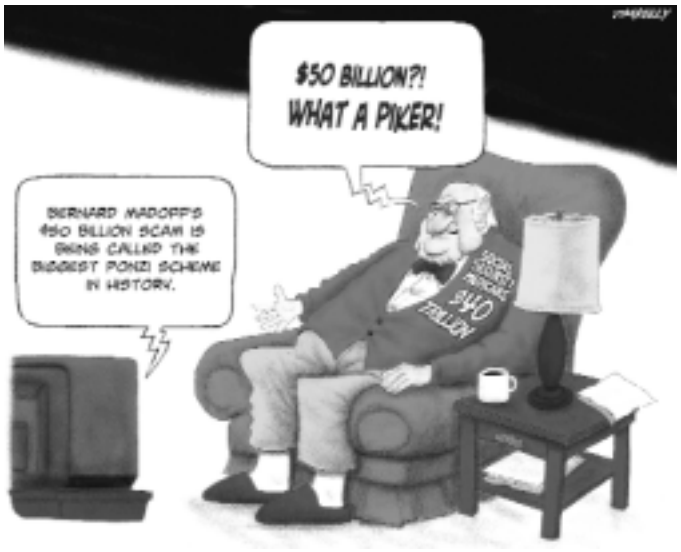
Madoff Is a Piker

BY JOHN STOSSEL

Bernard Madoff, who stands accused of bilking sophisticated investors out of $50 billion, reportedly told two of his executives that his business was "a giant Ponzi scheme."

Perpetrators of Ponzi schemes lead clients to believe their money is invested and that their profits are the fruits of the money manager's savvy. But in fact the "profits" are merely revenue provided by the next group of dupes. Eventually, when no more new dupes can be found, the scheme crashes.

Political leaders say Madoff's alleged crimes show what's wrong with the country. President Obama said the "massive fraud . . . was made possible in part because the regulators who were assigned to oversee Wall Street dropped the ball." Senate Majority Leader Harry Reid added, "[R]egulators have been asleep at the wheel."



Politicians go on and on about Wall Street "greed" and "irresponsibility."

But Madoff's scam was small compared to Ponzi schemes the government itself runs: Social Security and Medicare.

By now we all know the government does not invest our payroll taxes and pay our benefits with the profits our money earns. In the beginning, writes economic historian Charlotte Twight in *Dependent on D.C.*, Americans were told Social Security was an insurance program. But the government was unable to sustain that bald lie.

No-Trust Fund

In reality our money, rather than being invested and kept in an actual "trust fund," is immediately given to current retirees in Social Security benefits or to their healthcare providers in Medicare benefits. The government's promise to pay for your retirement pension and medical care is just a promise. And a lie.

In theory, the promise could be kept by raising taxes on future workers, but there won't be enough of them. Changing demographics are destroying the programs. A large working class can support a relatively small retired class, especially when life expectancy is 61 years and benefits don't begin until 65. That's how things were in the early years of Social Security. But when life expectancy grows to 80 and a large generational group—the baby boomers—retires expecting to be supported by a far smaller working class, that's trouble.

Ten years after Social Security passed in 1935, there were almost 42 workers for each retiree. Five years later, the ratio slipped to about 17 to 1. Now it's about 3.4 to 1. Thirty years from now, the ratio is projected to be 2 to 1.

John Stossel is co-anchor of ABC News' "20/20" and the author of Myths, Lies, and Downright Stupidity: Get Out the Shovel—Why Everything You Know is Wrong, *now in paperback. Copyright 2009 by JFS Productions, Inc. Distributed by Creators Syndicate, Inc.*

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Think of the burden on those two to three workers who'll have to support one retiree for 15 to 20 years.

The money just won't be there. In the next 75 years Social Security and Medicare have a combined unfunded liability of $40.3 trillion. Social Security's problems get most of the attention, but Medicare will be the killer. At present it accounts for all but $4.3 trillion of the unfunded liability, and as we aging boomers keep demanding new, improved, and more expensive medical care, the deficit will only get worse

Soon government will have to say what Madoff said: Sorry! The money's gone.

The government has no legal obligation to make good on its promises. Twice the U.S. Supreme Court ruled that Americans have no contractual rights regarding Social Security benefits. In 1960 (*Flemming v. Nestor*), the court said, "To engraft upon the Social Security system a concept of accrued property rights would deprive it of the flexibility and boldness in adjustment to ever-changing conditions which it demands."

Get that? You have no "accrued property rights" under Social Security. It's a welfare program that exists at the politicians' pleasure.

Either the government will stiff us outright or, more likely, cowardly politicians will pretend to honor their promises by printing so much extra money to write the checks that the dollar will be worth pennies.

If Bernie Madoff tried to foist Social Security and Medicare on us, he'd be arrested, prosecuted, and thrown in the hoosegow.

There's one thing I can say on behalf of Madoff: He never forced anyone to participate in his scheme. That's more than I can say for the government. Through taxation and inflation, it forces us to pay for all its schemes. FEE

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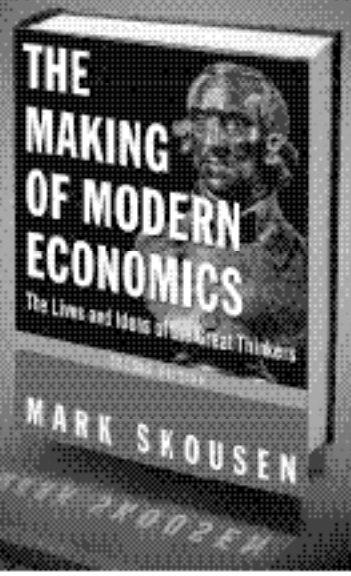

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Capital Letters

Is Energy Independence Desirable?

I thought that the title of the article by David R. Henderson, "Let's *Not* Be Energy Independent," in the October 2008 issue was shocking, and the content of the article did nothing to allay my concerns.

The author seems to think that one achieves independence by tariffs and import controls. He also seems to think it wonderful that hostile foreign governments are willing to trade something valuable to us for our fiat money. I think that it is morally reprehensible to be smug about defrauding people. Moreover, the Arabs and the Chinese may soon stop accepting these fiat dollars and are already using the ones they have to buy up prime United States assets. We learn nothing from the examples of the Indians who sold Manhattan Island for some beads. What will posterity think of us for selling our real estate and industry for Chinese trinkets and for oil that we desperately need but could have perfectly well produced for ourselves?

We do not need import controls to achieve energy independence. We simply need to repeal laws and regulations that make the United States a very hostile place for industry in general and energy production in particular. We need abundant affordable energy to produce any tangible products that people throughout the world could value. We told ourselves that they were buying our financial and business expertise, but we are rapidly finding out just how much that was worth.

Europe is waking up to the hazards of being dependent on Russian gas to keep from freezing to death in the winter. Being weak and dependent invites exploitation, not robust free trade. Restoring America's economy and freedom requires the best use of all of our own resources, including oil, coal, and nuclear, with the specific allocation determined in a free market. Perhaps other technologies will develop, but they will not arise through wishful thinking or government subsidies of economically infeasible "alternatives." The United States once again needs to be a magnet for foreign capital because of the rule of law and a favorable tax and regulatory climate. That was one of our biggest comparative advantages, one that we have progressively squandered.

—JANE M. ORIENT, M.D.
Tucson, Arizona

David Henderson replies:

Dr. Orient has three main arguments, but only one of them deals with my case against energy independence. I shall consider that one first.

Dr. Orient argues that we could achieve energy independence simply by repealing laws and regulations that make the United States a hostile place for energy production. She and I would probably agree on repealing 90 to 100 percent of those laws and regulations. The most important ones that affect oil are the restrictions on offshore drilling and on drilling in Alaska. Even doing that, though, would probably increase our domestic production by at most three million barrels per day. Given that we import about 12 million barrels per day, we would still need to import a substantial fraction of our oil and would not, therefore, be energy independent.

She also argues that our economic well-being and economic freedom would be enhanced by making "the best use of all our own resources, including oil, coal, and nuclear, with the specific allocation determined in a free market." But this certainly is not an argument against anything I wrote.

Finally, Dr. Orient gives an argument about foreign investment, but here she is arguing not with me but with herself. She clearly is upset about "selling our real estate and industry for Chinese trinkets and for oil." She seems to be getting at the fact that Chinese and other sellers who provide our imports use some of the proceeds to buy real estate, shares in companies, and companies themselves. In others words, they invest in the United States. Her tone suggests that she objects to this. But two paragraphs later, she claims that "United States once again needs to be a magnet for foreign capital." In other words, she wants foreign investment in the United States. So do I.

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Book Reviews

The Price of Everything: A Parable of Possibility and Prosperity

by Russell Roberts
Princeton University Press • 2008 • 216 pages • $24.95 hardcover and e-book

Reviewed by E. Frank Stephenson

The Price of Everything is George Mason University economist Russell Roberts's third novel for teaching economic principles. As with his previous offerings, *The Choice* and *The Invisible Heart*, *The Price of Everything* is outstanding.

The primary characters in *The Price of Everything* are Ruth Lieber, an economics professor and provost at Stanford University, and Ramon Fernandez, a Cuban immigrant tennis prodigy studying there. Ramon is saturated with hostility toward the market process, while Ruth has a strong appreciation of markets and liberty. Their conversations—serves and volleys of economic ideas—form the core of the book.

Whereas *The Choice* explained the economics of international trade, largely in response to early-1990s hysteria over competition from Japan, and *The Invisible Heart* explored the morality of capitalism, Roberts's primary interest in *The Price of Everything* is spontaneous order. That order can emerge without human design (indeed, that human design is antithetical to order) is a difficult concept, but Roberts's exposition is first-rate. He offers schools of fish, flocks of birds, and language as readily observable examples of emergent order. And *Freeman* readers will delight in Roberts's homage to Leonard Read's "I, Pencil": Ruth uses artifacts from a visit to a pencil factory as show-and-tell items while leading a class discussion of how manufacturing pencils illustrates emergent order.

Since planning is often useful in conducting our daily lives, it's only natural for students such as Ramon to press Ruth for a deeper understanding of how order can emerge with an invisible hand instead of a central plan. Here Roberts explains the crucial role that prices play in conveying "the particular circumstances of time and place" and coordinating the disparate plans of individuals. (Just as Ricardo and Smith inspired Roberts's two previous novels, Hayek underlies *The Price of Everything*.) An especially clever analogy between ant pheromones and prices as efficient mechanisms for disseminating information among beings that cannot possibly acquire or process all available knowledge helps Roberts illustrate this challenging idea.

Just as prices are fundamental to the market process, Ruth explains that the dynamism and entrepreneurial discovery embodied in emergent order are necessary for increasing human productivity and prosperity. On a micro level Ruth explains to Ramon that productivity enhancements such as gravity-fed food and watering systems have made it possible for the average worker on an egg farm to produce a staggering 120 million eggs per year. (As an aside, Ruth tells Ramon that if he's uncomfortable with modern industrial agricultural techniques, the market also caters to his taste by offering free-range chickens.) On a macro level Ruth asks Ramon to think how favorably the standard of living of a typical person today compares to even the wealthiest people who lived a century ago. That even people of modest means now have running water, modern appliances, and vastly improved medical care relative to yesterday's richest people testifies to the wealth-generating capability of the market process.

While explaining prices, emergent order, and prosperity, Roberts works several other economics topics into Ruth and Ramon's conversations. Among them are so-called price gouging (when Ramon leads a protest against Big Box after the fictitious retailer doubles its prices in response to an earthquake), alleged exploitation of workers by Wal-Mart, and the fallacy that labor markets share the zero-sum nature of a game of musical chairs (the fixed-number-of-jobs fallacy). He also has Ruth address common caricatures that economists are "pro-business" and assume people care only about money. (Readers familiar with Roberts's previous works will recognize his humane brand of economics.) It's noble work, and Roberts does it admirably.

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Although Roberts turns back caricatures of economists, one can also—at the risk of overanalyzing—detect criticism of the current state of economics instruction. Ramon has taken an introductory economics course. He recalls that supply and demand curves look like an "X" and is quick to suggest that government can improve on "market failure" arising from pollution. Nonetheless, Ramon's semester of economics apparently has not exposed him to Hayek and the notion of emergent order, nor has it dispelled any of his misguided thinking about the market process. Fortunately, there is an easy way for instructors to rectify such deficiencies in their teaching—adopt *The Price of Everything* for their courses.

Tyler Cowen, Roberts's colleague at George Mason, calls *The Price of Everything* "the best attempt to teach economics through fiction that the world has seen to date." That's high and well-deserved praise.

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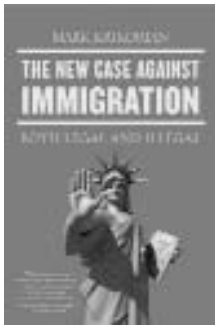
The New Case Against Immigration: Both Legal and Illegal

by Mark Krikorian
Sentinel • 2008 • 304 pages • $25.95 hardcover and e-book

Reviewed by Daniel Griswold



In his new book Mark Krikorian of the Center for Immigration Studies argues that immigration may have been good for America a century ago but not today—not because the immigrants have changed but because our nation has changed.

That's an interesting thesis, but as the book unfolds, the arguments sound more and more familiar. Krikorian argues that immigrants at current numbers can't be assimilated and that "mass immigration" jeopardizes national sovereignty and security, our quality of life, our jobs, wages, and wallets.

Despite his avowed goodwill toward immigrants, Krikorian's book is a polemic written to paint immigration in the worst possible light. The word *immigration* hardly ever appears without the modifier "mass" before it, even though the immigration rate today is far lower than a century ago. He dismisses efforts in Congress to legalize low-skilled immigration as "amnesty" legislation, even though the proposals would have imposed fines, probation, and security checks. He also ignores important findings in the immigration literature for the sake of advancing his argument.

Krikorian's worries about assimilation are nothing new and carry no more weight today than similar worries about the Italians, Poles, Irish, and Germans in past eras. Government promotion of multiculturalism and bilingual education don't help assimilation, but they are not the insurmountable hurdles that Krikorian paints: Studies show second- and third-generation immigrants are almost all fluent in English.

The book is at its xenophobic worst in the chapters on sovereignty and security. Krikorian warns that "Mexico City is moving to being, in effect, a second federal government that American mayors and governors must answer to . . . becoming a permanent participant in the day-to-day business of governance, [exercising] joint dominion" over American territory. As evidence for "this assault on American sovereignty" he mostly just musters quotes from Mexican officials urging the U.S. government to reform its immigration system.

That's only the beginning. While just about everybody recognizes that radical Islam is the most likely source of future terrorist activity against the United States, Krikorian is eager to bring every immigrant group under equal suspicion. In a section titled "Future Wars," the author manages to slander millions of normal, peaceful, hardworking immigrants from China, Korea, and Colombia. "Though the nearly 700,000 Korean immigrants here came from South Korea, there can be little doubt that the Communist regime in the north has a network of agents already in place among them," he writes, casting unwarranted suspicion on the corner grocer in Brooklyn and the worshippers at the Korean Central Presbyterian Church down the road from where I live in northern Virginia. In the same vein, Krikorian writes, "War with China is by no means a certainty, but it is clearly possible, and the nearly 1.9

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million Chinese immigrants throughout the United States, including a major presence in high-tech industries, represent a deep sea for Beijing's fish to swim in." Is this really a valid argument for turning away immigrants such as Taiwan-born Jerry Wang, cofounder of Yahoo!, or Beijing-born Liang Qiao, the Iowa-based coach of the American Olympic gymnast Shawn Johnson?

Turning to jobs and wages, Krikorian sounds like a class-warfare "liberal." "Mass immigration affects society as a whole by swelling the ranks of the poor, thinning out the middle class, and transferring wealth to the already wealthy," he asserts. The facts say otherwise. Studies show that immigration benefits the large majority of Americans, not just the wealthy. The middle class has not been thinning out but moving up: The shares of households earning below $35,000 a year and between $35,000 and $100,000 have both declined in the past 20 years as the share earning above $100,000 has grown. Fewer Americans were living under the poverty line in 2006 than in 1994, and the poverty rate has actually been trending down in the past 15 years—a time of robust immigration.

It is true that low-skilled immigrants consume more in government services than they pay in taxes, as Krikorian argues at length. But he dismisses the practicality of limiting access to welfare while glossing over the fact that the average immigrant and his or her descendents generate a sizeable net fiscal surplus for the government.

In the final chapter Krikorian advocates deep cuts in legal immigration and a sweeping crackdown on illegal immigration. Among his preferred coercive tools would be a national database of all U.S. workers, native and immigrant alike; uniform national ID documents; enlisting local law enforcement officers in pursuit of illegal immigrants; and even barring private property owners from renting to people without the right documents.

There are plenty of thoughtful questions to be considered when it comes to the role of immigration in a free, modern, and globally connected society. Unfortunately, this book brings nothing new to the discussion.

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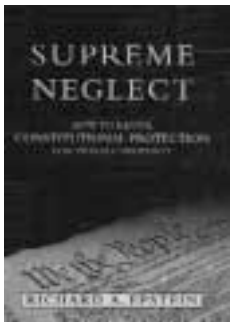
Supreme Neglect: How to Revive Constitutional Protection for Private Property

By Richard A. Epstein
Oxford • 2008 • 208 pages • $19.95

Reviewed by George C. Leef



The framers of the Constitution were acutely aware that politics—even in the highly limited democracy they envisioned—could be dangerous to private property. For that reason they added the "takings" clause to the Fifth Amendment: "Nor shall private property be taken for public use without just compensation." Unfortunately, like so much other constitutional language intended to defeat political attacks on liberty and property, those words have proven inadequate.

That is not to say that if the takings clause had been written differently we would have avoided the widespread destruction of property rights that has taken place. The trouble lies not in its wording but rather in the widespread belief shared by most politicians and judges that property rights must yield to a host of "social concerns." To address those concerns, the country has been beset with schemes that deprive people of their rights.

No American scholar has invested more time in analyzing the legalities and consequences of the erosion of property rights than University of Chicago law professor Richard Epstein. Oxford chose wisely in asking him to write the book on property rights in their "Inalienable Rights" series.

Supreme Neglect is not a dry legal treatise. Epstein has a serious purpose in mind that a dry treatise would not serve: "to offer a roadmap for the revival of property rights in the United States and for the social improvement that this constitutional change should usher in." Anyone who wants to understand what is at stake in the war over property rights should start with this book.

Epstein packs a lot into 169 pages. He begins with a general discussion of the benefits of private property, elaborating on the ways it facilitates social and eco-

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nomic progress by encouraging cooperation among people and directing resources to their most beneficial uses. Security in property rights allows people to find the ideal arrangements for the use (and the non-use) of land. With private property the owners reap the benefits of wise decisions and contracts but suffer the losses if they act mistakenly. Throughout the book Epstein contrasts the benefits that flow from private decision-making with the waste and folly of government interference.

The taking of private property through eminent domain is a "signature" issue with Epstein, and he drives home the point that government seizures of real estate for anything other than very narrow public uses ought not to be permitted. He was deeply involved in the 2005 Supreme Court case *Kelo v. New London,* where a thin majority held that takings for "economic development" were permissible. Epstein argues that rather than looking to government action to catalyze economic growth, especially in depressed areas, Americans should demand more freedom to acquire, invest in, and profit from real estate. The New London project proves a stark lesson in government blundering. Despite the city's taking of private property that wasn't even necessary for its grandiose plan, it languishes for want of commercial interest.

Epstein also shows that where government does pay property owners some compensation when it seizes their land or reduces its value, that compensation is usually far from adequate to make them whole. That enables politicians to parade in front of voters as great public benefactors for actions that do little good and for which the people probably wouldn't pay if they had to make full compensation. Thus hapless property owners are routinely victimized for cheap political stunts. Historic preservation is a good illustration. Heavy costs are imposed on those who own buildings that are designated as "historic," but how many people really care if some old property is maintained in its original, nineteenth-century condition? Only a few, who probably would not be willing to buy the property so they could preserve it themselves.

What Epstein terms the "exaction game" comes in for sharp criticism too. That is the nasty, extortionate ploy politicians have developed for compelling those who want to use their property to fund other, unrelated public "improvements" as well. Epstein blames the Supreme Court's "muddy and inconclusive analysis of exactions" for allowing municipal governments to force developers to pay for art museums, low-income housing, daycare centers, and so on. On this issue, like all the others he tackles here, Epstein shows judges the right path to take if they're interested in getting out of the mud.

Readers who expect to hear praise for such "conservative" justices as William Rehnquist and Antonin Scalia will be surprised to find that Epstein often criticizes them. His rigorous analysis steps on just about all the toes of Supreme Court justices past and present. Honest scholarship requires as much—the Court has been getting property rights cases wrong for a long time.

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Starved for Science: How Biotechnology Is Being Kept Out of Africa

by Robert Paarlberg
Harvard • 2008 • 256 pages • $24.95

Reviewed by Daniel Sacks

The escalating price of oil, the world's growing population, and its increasing demand for food have all received blame for rising worldwide food prices. What is often overlooked is that a significant portion of the world's population is unable to feed itself—because of politics. That is the greater, more frightening problem.

Today much of Africa remains hungry—almost a third of sub-Saharan Africa is undernourished. Since the late 1960s Africa's agricultural production has been in decline: Farm productivity has dropped and food imports have risen. African governments are complicit in the continent's hunger because they have hindered their citizens' ability to grow as much food as possible.

In *Starved for Science: How Biotechnology Is Being Kept Out of Africa*, Robert Paarlberg argues that Africa fails to

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feed itself in part because of the limited use of biotechnology and blames African governments and their European counterparts for that failure. *Starved for Science* explains how the increased use of genetically modified seeds would benefit African farmers—and stomachs—and explains why the use of biotechnology and other agricultural science is so limited in Africa.

Paarlberg, who teaches political science at Wellesley College, makes the case for science in agriculture by detailing the dramatic impact the vast changes in agriculture have had over the past few hundred years. The book focuses on the latter half of the twentieth century, when the Green Revolution swept through Asia and, through the use of technology, hugely bolstered agricultural production.

Africa desperately needs similar changes—yields per acre in some African countries are less than a tenth of yields in the United States. African farmers would gain greatly from better technologies and seeds. Unfortunately, government policies stand in their way.

Paarlberg blames developed-world biases for Africa's lack of agricultural improvement, especially a bias against genetically modified (GM) foods that dramatically limits Africa's ability to grow more. In part these biases stem from the developed world's ability to feed itself without a strong emphasis on the agricultural sciences or GM foods. Officials can therefore indulge environmentalist crusades against agricultural progress without apparent cost.

The European Union, non-governmental organizations, and the United Nations all played a role in exporting these biases to Africa, although the local governments also deserve a share of the blame. Instead of helping African farmers grow bigger crops to feed more people, European governments are doing the reverse, actively working to strengthen regulations in African countries, making the approval and use of GM seeds more difficult, and subsequently decreasing the potential productivity of African farmers. The governments of Germany, the Netherlands, and Norway, for example, have funded efforts to promote anti-GM regulatory frameworks and deprive farmers of the best tools they have. Similarly, the United Nations Environment Program (UNEP) exists not to help African farmers increase their output, but rather to increase the regulations that inhibit their farming.

Starved for Science makes a succinct case regarding the who's and why's of the barriers to Africa's biotechnology use, but there are a few components of Paarlberg's argument that could be stronger.

He spends little time discussing the specific problems that biotechnology can solve and the specific advantages of GM seeds. Although he details the possibilities of a drought-resistant seed, Paarlberg does not delve deeply into the successes of GM seeds in countries where they are currently being used, such as South Africa. With freedom to make their own decisions South African farmers are growing more food for themselves and their families and have enough extra to sell to others. Beyond increasing the local supply of food, having extra crops allows the farmers to increase the sizes of their farms, create jobs, start other businesses, and save money for the future.

The other incomplete aspect of *Starved for Science* deals with the incentives Africans face when debating growing GM crops. Even when they have the choice of using GM seeds they have to decide if it's worth doing so, since European markets usually ban GM goods. The book would have been improved if Paarlberg had investigated the tradeoffs here more thoroughly.

Allowing free rein for biotechnology would be an important step toward eliminating the hunger that plagues Africa. The sad truth is that politics is apt to continue obstructing that and other avenues of progress. FEE

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Where Does Your Vote Really Count?

BY WALTER E. WILLIAMS

To encourage us to participate in the political process, we are told that every vote counts. That is true if one is adding up the total votes, but what is the likelihood of any one person's vote affecting the outcome of a presidential election? Simply put, it is equal to the probability that the person's state will be necessary for an electoral college win multiplied by the probability that the vote in his state will be tied without that additional vote. According to Professors Andrew Gelman, Nate Silver, and Aaron Edlin's paper, "What Is the Probability Your Vote Will Make a Difference?" the chances that the average American's vote would have made a difference in the 2008 presidential election was about one in 60 million. The chances of winning your state lotto are about one in 15 million—about four times greater than the chances of your vote determining the outcome of last year's presidential election.

Don't misinterpret me. I am not suggesting that people not vote. Most Americans see voting as their civic duty and, despite the evidence shown by Professors Gelman, Silver, and Edlin, people have a feeling that their vote counts. If one thinks that his vote makes a difference, that is a worthy benefit deserving of the time and effort it takes to vote.

There's no older story in the political arena than that of the candidate who promises one thing when he campaigns and does something else when he wins office.

You Get What You Pay For

Voting has other problems in addition to the relative unimportance of each individual vote. When one votes for a particular candidate, is there any way to be sure that one will get what one votes for? There's no older story in the political arena than that of the candidate who promises one thing when he campaigns and does something else when he wins office. Moreover, if he lives up to a promise made to one group of Americans, it will always come at the expense of another. Some political promises are incredible, such as Barack Obama's promise that he would work to unite Christians, Muslims, and Jews. That's true political arrogance in light of the hundreds of years of sometimes murderous conflict between these groups.

Americans cast millions upon millions of votes—that is, they make decisions—in the non-political arena where individual votes do count and where there is a much higher probability of being satisfied with the outcome. Moreover, what they get in return for their vote does not come at the expense of another. That arena is the marketplace.

In our wallets we have what amounts to ballot slips; we can think of them as dollar votes. When we take, say, nine of them and "vote" for two pounds of steak, we are fairly certain about the outcome. We get the two pounds of steak. If we don't get the outcome we voted for—we get, say, steak of poor quality—there is swift retribution. We can simply fire the seller by taking our business elsewhere. We act unilaterally and don't have to bother with costly organizing. Very often simply the threat of taking our business elsewhere is enough to get some kind of remedy.

An individual's threat to vote for a politician's opponent as an expression of dissatisfaction with the politician's actions, on the other hand, is not likely to carry as much weight.

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There is another contrast between the market arena and the political arena that can be appreciated by asking what draws the greatest public complaints: Is it market-provided goods and services, such as computers, televisions, clothing, and food? Or is it government-provided services, such as public schools, postal services, and motor vehicle departments? In the case of market-provided goods and services, the prospect of profit gives providers an incentive to please customers. The government sector, however, is not-for-profit, so it suffers no losses when it fails to please "customers."

Better for Poor People, Too

You might say, "That's okay, Williams, if you have enough dollar votes. But what about poor people?" Poor people are far better served in the market arena than the political arena. Check this out. If you visit a poor neighborhood, you will see some nice clothing, some nice cars, some nice food, and maybe even some nice homes—no nice schools. Why not at least some nice schools? The explanation is simple. Clothing, cars, food, and houses are allocated through the market mechanism. Schools are allocated through the political mechanism. By the way, if you are a member of a minority, it is in your interest to minimize those decisions over your life made in the political arena, where the majority rules.

There is another unappreciated feature of the market arena. It reduces the potential for human conflict. Different Americans have different and intense preferences for cars, food, clothing, and entertainment. When is the last time you heard about Chrysler lovers fighting with Lexus lovers? It seldom if ever happens. Why? Those who love Chryslers get what they want, and those who love Lexuses get what they want, and each can live in peace with one another.

It is a different story in government-provided education. Some parents wish for their children to recite a morning prayer in schools. Other parents are repulsed by the idea. The fact that education is produced by government means there is either going to be prayer in school or no prayer in school. Parents must enter into conflict with one another. Why? If, for example, the parent who wishes for prayers in school loses the political battle, that parent will not have his wishes met. Of course he can send his child to a non-government school that has morning prayers, but through the tax code he is forced to continue paying for school services for which he has no use.

The prime feature of political decision-making is that it's a zero-sum game. One person or group's gain, of necessity, comes at the expense of another person or group.

If government decided whether Chryslers or Lexuses would be produced, we would see conflict between lovers of Chryslers and Lexuses.

The prime feature of political decision-making is that it's a zero-sum game. One person's or group's gain, of necessity, comes at the expense of another person or group. As such, political allocation of resources is conflict-enhancing while market allocation is conflict-reducing. The greater the number of decisions made in the political arena the greater the potential for conflict.

I never cease to be amazed by Americans' faith in government and the political arena, whose essence is coercion, and their suspicion of the market arena, whose essence is peaceable, voluntary exchange. FEE

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